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Disposable Personal Goodwill, Frosty the Snowman, and *Martin Ice Cream* All Melt Away in the Bright Sunlight of Analysis

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I. INTRODUCTION

The current rage in dispositional tax planning for closely-held C corporations is to bifurcate the sale transaction into two components comprising: (a) a sale by (i) the target C corporation’s shareholders of their target C corporation stock or (ii) the target C corporation of its assets; and (b) a sale by some or all of the target C corporation’s share-

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holders of “personal goodwill” associated with the business conducted by the target C corporation. The documented purchase price paid for the first component of the transaction (either the stock of the C corporation or the assets of the C corporation) is based on a fair market value determination that excludes consideration of the personal goodwill component of the transaction. If successful, this tax planning technique allows the selling shareholders to report only shareholder-level capital gain on the personal goodwill component of the transaction and allows the buyer to claim that this portion of the purchase price is allocable to an acquired intangible, i.e., goodwill, that is amortizable over fifteen years under § 197.¹ More specifically, from the selling shareholders’ perspective, if the first component of the transaction involves a sale of the target C corporation’s assets, the portion of the purchase price attributable to the personal goodwill component of the transaction does not bear the burden of a corporate level of taxation. From the buyer’s perspective, if the first component of the transaction involves a purchase of the target C corporation’s stock, the portion of the purchase price attributable to the personal goodwill component of the transaction is not capitalized into the stock.²

This planning is premised on the position that certain goodwill associated with the target C corporation’s business can be, and is in fact, owned for tax purposes, by one or more shareholders. If all goodwill associated with the target C corporation’s business activities were in fact owned for tax purposes by the target C corporation, then the personal goodwill component of the transaction is properly viewed as a sale by the target C corporation of such goodwill creating a corporate-level gain, followed by a distribution from the target C corporation to the shareholders, which in turn creates a shareholder-level gain.³ If,

1. I.R.C. § 197 (2006).

2. A premise for this planning (in addition to the premise that is the subject of this Article) is that the target C corporation’s business has a fair market value that exceeds the fair market value of the assets shown on the target C corporation’s balance sheet. Thus, some value is attributable to self-created goodwill (i.e., goodwill that has not been acquired and thus is not reflected on the balance sheet). See the discussion *infra* Part III. As a result, if the first component of the transaction is a sale by the target C corporation of its assets, the buyer generally would treat a portion of the purchase price as allocable to goodwill and thus to the purchase of an intangible asset amortizable under § 197 regardless of the presence of any personal goodwill. Accordingly, if the first component of the transaction is a sale by the target C corporation of its assets, the principal purported benefit from the personal goodwill planning technique would be the avoidance of corporate-level taxation. If the first component of the transaction was a sale of the target C corporation’s stock, the purported benefits from the personal goodwill planning technique would include both the avoidance of corporate-level taxation and the acquisition by the buyer of an asset amortizable under § 197.

3. Howard v. United States, No. CV-08-365-RMP, 2010 WL 3061626 (E.D. Wash. Jul. 30, 2010), *aff’d* 448 F. App’x 752 (9th Cir. 2011). The transaction might also be viewed as a distribution by the target C corporation of the goodwill to the

however, the personal goodwill can be, and in fact is, owned by the selling shareholders and can be, and in fact is, sold by the selling shareholders to the buyer for tax purposes, then its disposition is not subject to corporate-level taxation.

Although this planning has garnered much attention recently and could provide significant tax benefits if effective, we believe it deserves further scrutiny before being accepted as an appropriate component of dispositional tax planning for closely-held businesses. This planning technique also highlights the continuing horizontal equity problems associated with the current tax law's treatment of closely-held businesses. In Part II of this article, we discuss the place that this tax planning technique occupies within a historical context. In Part III, we set forth a substantive discussion of the issues raised by the technique. In Part IV, we discuss the tax policy implications that are raised by the existing application of the corporate income tax regime. Finally, in Part V, we discuss some final thoughts about the implications of the analysis contained in this paper.

II. HISTORICAL BACKGROUND

A. Pre-1986 Law

The ability to distribute appreciated goodwill out of corporate solution without bearing corporate-level taxation on associated built-in gain was achievable under law existing prior to 1986. In *General Utilities & Operating Co. v. Helvering*,⁴ the Supreme Court held that a distribution of assets by a corporation to its shareholders did not constitute a sale or exchange of the distributed assets and accordingly the distributing corporation did not incur a taxable gain or loss from the distribution.⁵ The *General Utilities* doctrine, as it came to be known, was codified in the Internal Revenue Code of 1954 in old § 311(a)(2) as to nonliquidating distributions and in old § 336 with respect to liquidating distributions.

While the *General Utilities* doctrine protected corporations from incurring tax upon a distribution of assets, the shareholders would recognize shareholder-level gain on the distribution equal to the excess of the fair market value of the distributed assets over the shareholder's stock basis. When the shareholder later sold the distributed assets to

shareholder followed by a sale of such goodwill by the shareholder to the buyer. The result, however, would be the same.

4. *Gen. Utils. & Operating Co. v. Helvering*, 296 U.S. 200 (1935), *superseded by statute*, Tax Reform Act of 1986, Pub. L. No. 99-514, § 631(a), 100 Stat. 2085, 2269.
5. See 1 BORIS I. BITTKER & JAMES EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶8.20 (7th ed. 2006 & Supp. 2011); *see also* H.R. REP. NO. 99-841, pt. 2, at 98 (1986) (reporting that the *General Utilities* doctrine is "said to be codified" in statutory provisions recognizing no gain or loss on a distribution of assets to shareholders in liquidation if certain conditions are met).

a buyer, there was no further gain to be realized on the sale except to the extent the buyer paid more than the fair market value of the assets at the time of their distribution.⁶ The buyer would take the assets with a basis equal to the buyer's purchase price. This technique was widely understood⁷ and widely utilized.⁸ The ability to distribute appreciated assets out of corporate solution without incurring a corporate-level tax is exactly what Congress deemed to be an area in need of fundamental reform in 1986.⁹

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6. *Compare* *Comm'r v. Court Holding Co.*, 324 U.S. 331, 334 (1945) (corporation was taxed on built-in gain on assets distributed prior to their sale by the shareholders because "[t]he incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title."), *with* *United States v. Cumberland Pub. Ser. Co.*, 338 U.S. 451, 454 (1950) (Court refused to attribute a shareholder sale of distributed assets to the corporation where the shareholders had first attempted to sell their stock to the buyer and then offered to liquidate the corporation and sell the assets; the *Court Holding* decision was distinguished because in *Court Holding* the sole purpose of the so-called liquidation was to disguise a corporate sale). The uncertainty caused by these two cases led Congress in 1954 to enact old § 337, which ordinarily eliminated a tax at the corporate-level on liquidation-sale transactions (except for recapture items, installment obligations, and nonbulk sales of inventory), whether the sale was made directly by the corporation or was imputed to it under the *Court Holding* doctrine. Congress repealed old § 337 in 1986 because its continued existence was inconsistent with the repeal of the *General Utilities* doctrine.
 7. *See, e.g.*, AMER. LAW INST., FEDERAL INCOME TAX PROJECT: SUBCHAPTER C, PROPOSALS ON CORPORATE ACQUISITIONS AND DISPOSITIONS 102–19 (1982); Beynard Wolfman, *Corporate Distributions of Appreciated Property: The Case for Repeal of the General Utilities Doctrine*, 22 SAN DIEGO L. REV. 81 (1985); John S. Nolan, *Taxing Corporate Distributions of Appreciated Property: Repeal of the General Utilities Doctrine and Relief Measures*, 22 SAN DIEGO L. REV. 97 (1985); Peter L. Faber et al., *Income Taxation of Corporations Making Distributions With Respect to Their Stock*, 37 TAX LAW. 625 (1984); Edward J. Hawkins, *A Discussion of the Repeal of General Utilities*, 37 TAX LAW. 641 (1984).
 8. *See, e.g.*, *Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954); *Esmark, Inc. v. Comm'r*, 90 T.C. 171 (1988), *aff'd* 886 F.2d 1318 (7th Cir. 1989).
 9. *See* H.R. REP. NO. 99-426, at 282 (1985) (footnote omitted) ("[T]he *General Utilities* rule tends to undermine the corporate income tax. Under normally applicable tax principles, nonrecognition of gain is available only if the transferee takes a carryover basis in the transferred property, thus assuring that a tax will eventually be collected on the appreciation. Where the *General Utilities* rule applies, assets generally are permitted to leave corporate solution and to take a stepped-up basis in the hands of the transferee without the imposition of a corporate-level tax. Thus, the effect of the rule is to grant a permanent exemption from the corporate income tax."). The price of this basis step up is, at most, a single shareholder-level capital gains tax (and perhaps recapture, tax benefit, and other similar amounts). In some cases, moreover, payment of the capital gains tax is deferred because the shareholder's gain is reported under the installment method.

B. Tax Reform Act of 1986

In 1986, save for distributions that qualify for non-recognition treatment under § 355,¹⁰ Congress repealed the last vestiges of the *General Utilities* doctrine.¹¹ The intent of this major tax reform effort was to ensure that built-in gain property residing in corporate solution would be subject to corporate-level taxation when and if such property was distributed out of corporate solution¹² except where the taxpayer was able to meet the rigorous requirements of § 355. Congress viewed the repeal of the *General Utilities* doctrine as a major reform effort with broad-reaching impact. In this regard, the Tax Reform Act of 1986 (1986 Act) was premised on the "classic view" that a corporation should be taxed separately from and in addition to the tax imposed on its owners. Thus, corporate-level goodwill could no longer be distributed as part of a liquidating distribution to the shareholders without incurrance of a corporate-level tax. Congress authorized the Treasury Department to issue regulations to ensure that the purposes of the repeal of the *General Utilities* doctrine were not circumvented through the use of any provision of the law or regulations.¹³ At the

10. In 1990, Congress subsequently tightened the restrictions on § 355 by enacting § 355(d) to further protect against the use of § 355 as a technique to indirectly sell a subsidiary without corporate-level gain. Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, § 11321, 104 Stat. 1388-460 (codified as amended in I.R.C. § 355 (2006)).
11. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 631(a), 100 Stat. 2085, 2269; I.R.C. § 311(b)(2) (2006); I.R.C. § 336(a) (2006).
12. See H.R. REP. NO. 99-841, pt. 2, at 204 (1986) (Conf. Rep.) ("The repeal of the *General Utilities* doctrine is designed to require the corporate-level recognition of gain on a corporation's sale or distribution of appreciated property, irrespective of whether it occurs in a liquidating or non-liquidating context.").
13. See I.R.C. § 337(d) (2006); H.R. REP. NO. 99-841, pt. 2, at 204 (1986). Shortly after the 1986 Act, techniques were developed to circumvent the repeal of the *General Utilities* doctrine. One such technique, the son-of-mirror transaction, involved a situation in which an acquiring company would acquire the stock of a target company at fair market value. After the acquisition, the acquiring company would cause the target company to distribute its wanted assets to the acquirer, thus generating gain within the acquirer's consolidated group and thereby increasing the acquirer's basis in the stock of the target by the amount of that gain. The acquirer then could sell the target's stock at a time when only unwanted assets were held by the target company. As a result, an artificial loss was created that approximated the amount of the previously recognized gain that occurred upon the distribution of the wanted assets out of the target company. The IRS immediately responded to the son-of-mirror technique by issuing Notice 87-14, 1987-1 C.B. 445, stating it would deny the intended tax benefits of a son-of-mirror type transaction by future regulations having retroactive effect. On Sept. 19, 1991, the IRS and Treasury Department published Treas. Reg. § 1.1502-20 (the loss disallowance rule). See T.D. 8364, 1991-2 C.B. 43. On July 6, 2001, in *Rite Aid Corp. v. United States*, 255 F.3d 1357 (Fed. Cir. 2001), the Court of Appeals for the Federal Circuit held that the duplicated loss provisions of the loss disallowance rules were an invalid exercise of regulatory authority. Because only the loss duplication factor of Treas. Reg. § 1.1502-20 was at issue in *Rite Aid*, the

time, there were calls to adopt an integrated shareholder-corporate tax regime,¹⁴ but those calls were rejected.

Moreover, the 1986 Act reduced individual tax rates to a maximum tax rate of 28% while the maximum corporate tax rate, which had historically been lower than the individual tax rate, was reduced to 34%. This reform's effect was that the combined all-in shareholder-corporate tax rate that applies to C corporations was raised more than 24% higher than the combined all-in owner-company tax rate that applies to pass-through entities (e.g., S corporations and partnerships).¹⁵

IRS believes that the finding of invalidity applied only to that factor and not to the factors dealing with the son-of-mirror problem. See Notice 2002-11, 2002-1 C.B. 526 ("It is the Service's position that the *Rite Aid* opinion implicates only the loss duplication aspect of the loss disallowance regulation . . ."). In response to the *Rite Aid* decision, the IRS and Treasury Department promulgated two regulations to replace the loss disallowance rules. The first, Temp. Treas. Reg. § 1.337(d)-2T (temporary *General Utilities* regulation), was published on March 12, 2002, to address the circumvention of *General Utilities* repeal. See T.D. 8984, 2002-1 C.B. 668. The second, Temp. Treas. Reg. § 1.1502-35T, was published on March 14, 2003, to address the inappropriate duplication of loss. See T.D. 9048, 2003-1 C.B. 645. T.D. 9048 also included certain related provisions promulgated under Temp. Treas. Reg. §§ 1.1502-21T and § 1.1502-32T. On March 3, 2005, the temporary regulation was adopted without substantive change as final Treas. Reg. § 1.337(d)-2. See T.D. 9187, 2005-1 C.B. 778. On September 17, 2008, the IRS and Treasury Department issued final unified rules for loss on subsidiary stock through Treas. Reg. § 1.1502-36. See T.D. 9424, 2008-2 C.B. 1012. For a discussion of the final unified loss disallowance regulations that now represent the end of this sordid tale, see David B. Friedel, *Final Loss Disallowance Rules: A New World Order*, J. CORP. TAX'N, Nov.-Dec. 2008, at 33 ("To call these final rules complicated would be a great understatement."). For a thorough analysis of the final regulations, see DON LEATHERMAN, *A Survey of §1.1502-36*, in THE CORPORATE TAX SERIES: STRATEGIES FOR ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, REORGANIZATIONS, & RESTRUCTURINGS (2010).

14. See U.S. DEP'T OF THE TREASURY, THE PRESIDENT'S PROPOSAL TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY, 120-29 (1985), <http://www.treasury.gov/resource-center/tax-policy/Documents/pres85All.pdf>; U.S. DEP'T OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH: THE TREASURY DEPARTMENT REPORT TO THE PRESIDENT, VOL. 2, 134-44 (1984), <http://www.treasury.gov/resource-center/tax-policy/Documents/tres84v2All.pdf>. For an analysis of efforts for shareholder-corporate integration in the post-World War II era, see Steven A. Bank, *The Rise and Fall of Post-World War II Corporate Tax Reform*, 73 LAW & CONTEMP. PROBS. 207 (2010).
15. The double tax was ameliorated somewhat by enactment of the 15% rate on dividends and capital gains in 2003. See Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, 117 Stat. 752. However, even with this reduced rate, the total tax burden for the C corporation form is still higher at 44.75% (35% corporate tax plus 15% x 65% after-corporate tax profits) versus the top individual tax rate of 35% under current law. This provision was originally set to expire for tax years beginning after December 31, 2008, but the sunset date for the preferential 15% rate on dividends and capital gains was extended to December 31, 2010 by the Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, 120 Stat. 345 (2006). Congress again extended the sunset date to December 31, 2012, in the Tax Relief, Unemployment Insurance Reauthorization,

C. Post-1986 Reaction

Notwithstanding the bold reform Congress instituted with the repeal of the *General Utilities* doctrine and its efforts to preserve the corporate tax base, Congress left taxpayers with the ability to choose whether to conduct their business activities in pass-through entities or through separately taxable C corporations. In response to the reforms implemented as part of the 1986 Act, the tax community has engaged in an ongoing effort to transform the manner in which business is conducted in the United States by migrating business activities into pass-through entity structures.¹⁶ Perhaps as a result of this effort, an impressive number of C corporations have been electing to change from C corporation status to S corporation status.¹⁷ This trend can be traced back to the adoption of the reforms implemented as part of the 1986 Act.¹⁸ However, the utility of such conversions has limits.

In this regard, S corporation status allows pass-through treatment for income earned prospectively. However, § 1374 imposes a tax on a converted C corporation's built-in gains¹⁹ that are recognized during

and Job Creation Act of 2010 Pub. L. No. 111-312, 125 Stat. 3296. The current administration has criticized any further extension of the sunset date. Press Release, Office of the White House (August 2, 2011).

16. According to calculations based on IRS Statistics of Income data from 2004 to 2008, individual owners of flow-through businesses earned 54% of all business net income. Robert Carroll and Gerald Prante, *The Flow-Through Business Sector and Tax Reform*, S-CORPORATION ASS'N, at 9 (April 2011), <http://www.s-corp.org/wp-content/uploads/2011/04/Flow-Through-Report-Final-2011-04-08.pdf>.
17. During the 2000–2006 time period, between 78,000 and 97,000 C corporations converted to S corporations per year, representing 23%–31% of all new corporations. See U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-195, TAX GAP: ACTIONS NEEDED TO ADDRESS NON-COMPLIANCE WITH S CORPORATION TAX RULES 9 (2009).
18. Whereas the annual growth in the number of S corporation returns was 9.5% during the 1959–1986 period, the number of S corporations grew by 36% between 1986 and 1987. George A. Plesko, *The Role of Taxes in Organizational Choice: S Conversions After the Tax Reform Act of 1986*, MASS. INST. OF TECH., <http://web.mit.edu/gplesko/www/Plesko%20Sconv.pdf> (last visited Feb. 18, 2012). S corporations represented approximately 5% of businesses in 1986. JOINT COMM. ON TAX'N, *Tax Reform: Selected Federal Tax Issues Relating to Small Business and Choice of Entity* (June 4, 2008), <http://www.jct.gov/x-48-08.pdf>. In 2006, S corporations represented 12.6% of all businesses and grew by 35% from 2000 to 2006 to account for nearly 4 million businesses. GAO-10-195, *supra*, at 9.
19. In general terms, built-in gain is the amount by which the fair market value of the assets of a converted C corporation exceeds the aggregate adjusted bases of the assets. I.R.C. § 1374(d)(1) (Supp. 2010). The tax is imposed if: (i) the S election was made after 1986; (ii) the converted C corporation has a net recognized built-in gain within the recognition period; or (iii) the net recognized built-in gain for the tax year does not exceed the net unrealized built-in gain minus the net recognized built-in gain for prior years in the recognition period, to the extent that such gains were subject to tax. *Id.* § 1374(c).

the prescribed post-S election recognition period.²⁰ As a result, where possible, tax advisors have advised closely-held businesses to convert from C corporation status to S corporation status, and then to delay any sale of appreciated built-in gain assets until after the close of the § 1374 recognition period. Such planning can minimize corporate-level tax under certain circumstances. However, given the extended length of the recognition period for purposes of § 1374's application (minimum seven years for dispositions occurring in 2009 and 2010,²¹ minimum of five years for dispositions occurring in 2011,²² and a minimum of ten years for dispositions occurring in all other years²³), this delay is unacceptably long when the shareholders desire to sell the business in the near future.²⁴ What is more, the conversion to S corporation status imposes mechanical restrictions on the number of shareholders, the types and residency of shareholders, and the types of stock that can be owned by shareholders.²⁵ Thus, although conversion to an S corporation provides a path to avoid corporate-level taxation, the election of S corporation status is not an immediate path to the avoidance of corporate-level tax on appreciated built-in gain property. Conversion also creates some operational and ownership constraints that would not exist if the company were operated in a partnership or C corporation form.

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20. The "recognition period" generally is the ten-year period beginning on the first day on which the corporation is taxed as an S corporation or acquires C corporation assets in a carryover basis transaction. *Id.* § 1374(d)(7), (8). Thus, a disposition of appreciated property during this period of time will be subject to a corporate-level tax in addition to the shareholder-level tax. However, Congress has shortened the recognition period in two instances. First, for taxable years beginning in 2009 and 2010, no tax is imposed on the net built-in gain recognized in either of those years if the seventh taxable year is in the ten-year period preceding that taxable year. *Id.* § 1374(d)(7)(B). The second instance where Congress shortened the recognition period was in The Small Business Jobs Act of 2010, which temporarily shortens the recognition period to five years but only for dispositions occurring in taxable years beginning in 2011. The tax is computed by applying the highest corporate income tax rate to the converted C corporation's net recognized built-in gain for the taxable year. *Id.* § 1374(b)(1).
 21. *Id.* § 1374(d)(7)(B), *amended by* American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 1251, 123 Stat. 115, 342.
 22. Small Business Jobs Act of 2010, Pub. L. No. 111-240, § 2014(a), 124 Stat. 2504, 2556. Enacted on September 27, 2010, the Act reduces the S corporation built-in gain holding period from ten years to seven years for dispositions occurring during 2009 and 2010 and to five years for dispositions occurring during 2011. *Id.*; I.R.C. § 1374(d)(7)(B).
 23. I.R.C. § 1374(d)(8)(B)(i); S. REP. NO. 100-445, at 65 (1988).
 24. *See, e.g.,* Martin Ice Cream v. Comm'r, 110 T.C. 189, 191, 203 (1998) (Martin Ice Cream, a historic C corporation, elected S corporation status on November 1, 1987 but was sold shortly thereafter on July 22, 1988).
 25. *See* JAMES S. EUSTICE & JOEL D. KUNTZ, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶5.01 (4th ed. 2001 & Supp. 2011).

Another alternative for reducing exposure to corporate-level taxation is to convert from C corporation status to partnership status.²⁶ Since the advent of the so-called "check-the-box" regime in 1997, taxpayers have been given the ability to elect the tax classification of business entities organized as partnerships or limited liability companies under state law.²⁷ Accordingly, it is relatively convenient to preserve the non-tax benefits provided by corporate status (principally limited liability) while converting to an organizational form that can be taxed as a partnership for federal tax purposes. However, in light of the repeal of the *General Utilities* doctrine, a significant disadvantage of this alternative is that the conversion of an existing C corporation into a tax partnership generally represents a taxable event to both the C corporation and its shareholders.²⁸ Depending on the existence of tax attributes such as a net operating loss carryforward or the valuation of the overall business, this form of tax planning may nonetheless make sense, particularly in a market downturn. However, the cost of such a conversion often is prohibitively expensive. Accordingly, notwithstanding the opportunities afforded for doing so, many closely-held C corporations are unable to usefully convert to pass-through status in a timely manner.

D. Section 7704

Shortly after the 1986 Act was enacted, several publicly traded companies attempted to disincorporate by means of the use of a master limited partnership.²⁹ In response to this effort and to protect the corporate tax base from what Congress perceived to be a significant threat,³⁰ Congress enacted § 7704. The statute in general prevents publicly traded entities, with some important exceptions, from being treated as pass-through entities.³¹ Although Congress re-

26. Treas. Reg. § 301.7701-3(g)(1)(ii) (2011). The total number of partnerships actually declined between 1986 and 1987 due in part to changes to the passive activity loss rules, but the amount of income reported by partnerships with positive ordinary income increased by 9% during that period. Susan Nelson & Tom Pet-ska, *Partnerships, Passive Losses, and Tax Reform*, 9 SOI BULL. 31 (Winter 1990), available at <http://www.irs.gov/pub/irs-soi/81-87papltxrf.pdf>.

27. Simplification of Entity Classification Rules, 61 Fed. Reg. 66,584, 66,588–66,592 (Dec. 18, 1996), revising Treas. Reg. §§ 301.7701-1, -2, & -3. The effective date of the regulations was January 1, 1997. See also I.R.S. Notice 95-14, 1995-1 C.B. 297 (stating that IRS and the Treasury Department are "considering simplifying the classification regulations"). See Treas. Reg. §§ 301.7701-1(f), 301.7701-2(e), & 301.7701-3(f)(1).

28. I.R.C. § 311(b) (2006); *Id.* § 331.

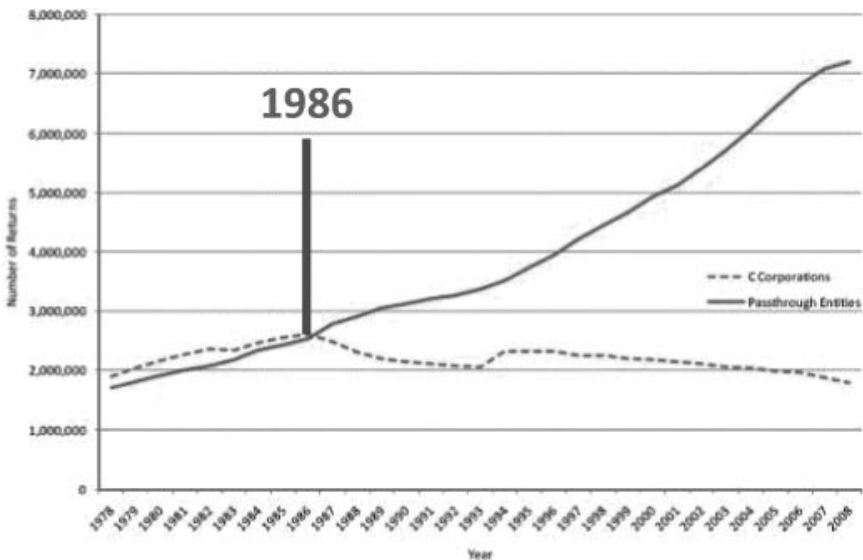
29. H.R. REP. NO. 100-391, pt. 1, at 1065 (1987).

30. See Marvin F. Milich, *Master Limited Partnerships*, 20 REAL EST. L.J. 54, 63 (1991).

31. Congress enacted § 7704 in the Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 10211, 101 Stat. 1330, 1330–403–405 (1987). This public law

sponded by protecting against the disincorporation of the corporate tax base with respect to publicly-traded entities through the enactment of § 7704, Congress in 1987 again retained the taxpayers' ability to utilize partnerships or S corporations for nonpublicly traded businesses. In testimony before the Joint Select Committee on Deficit Reduction, Thomas Barthold, Joint Committee on Taxation Chief of Staff, provided the following diagram, which well summarizes the transformation that occurred in the tax status of how business was conducted since the 1986 Act:³²

Number of C Corporation Returns Compared to the Sum of S Corporation and Partnership Returns, 1978-2008



As indicated by the above chart, the use of C corporations to conduct business activity continues to decline, and so the corporate income tax applies to a shrinking subset of business activities conducted within the United States. Thus, although Congress blocked the exit for most publicly traded companies through the adoption of § 7704, it

also enacted I.R.C. § 469(k), which applies the passive loss rules to master limited partnerships, and I.R.C. § 512(c)(2), which treats income from master limited partnerships as unrelated trade or business income.

32. *Testimony of the Staff of the J. Comm. on Taxation Before the Select Comm. on Deficit Reduction*, 112th Cong. 10 (2011) (testimony of Thomas A. Barthold, Chief of Staff of the Joint Committee on Taxation), <http://www.jct.gov/publications.html?func=startdown&id=4363> (line in chart highlighting 1986 date added by the authors).

left in place the means of side-stepping the corporate tax regime for nonpublicly traded companies by leaving in place the ability of taxpayers to conduct their business in pass-through entity structures.

III. SUBSTANTIVE ANALYSIS

In situations where the ability to change the status of a C corporation into a pass-through entity does not provide an effective means to timely escape the corporate-level tax, tax planners have attempted to argue that some or all of the goodwill associated with the business conducted by the C corporation is in fact not a corporate asset but instead is a shareholder asset, i.e., “personal goodwill,” the disposition of which is not subject to corporate-level taxation. To help guide the discussion of this section, this Article posits the following hypothetical fact pattern in order to frame the relevant issues for analysis:

EXAMPLE: The sole Shareholder organized a C corporation and has been directly involved in managing and developing the business that it conducts. The Shareholder is an employee and has received a salary since the inception of the C corporation. The Shareholder has developed customer contacts, client relationships, customer lists, and has built the reputation of the C corporation. No formal employment agreement exists and no intangible property agreements have been put into place between the Shareholder and the C corporation.³³ After many years of developing the business, the Shareholder now desires to sell the C corporation for \$50 million. The tangible assets of the C corporation have a book value and fair market value of \$5 million and a tax basis of \$2 million. The Shareholder claims that the remaining \$45 million of value is attributable to goodwill owned and created by the Shareholder. Thus, the Shareholder wants to claim that \$45 million of the purchase price represents a payment for the Shareholder’s personal goodwill that is not subject to corporate-level taxation, and thus is subject to taxation only once (to the Shareholder) at long-term capital gains rates.³⁴

Because goodwill was not subject to depreciation prior to the adoption of § 197 in 1993, significant litigation under prior law occurred over the ability of taxpayers to identify separate and distinct intangible assets that have a fixed life (and, thus, are subject to an allowance

33. Consequently, the arrangement between the Shareholder and the controlled C corporation in the **Example** fails to meet the requirements for a qualified cost-sharing agreement within the meaning of the Treasury regulations. See Treas. Reg. § 1.482-7T(b) and (k) (2010).

34. The publication of recent articles regarding personal goodwill is indicative of growing interest in this planning technique. See Michael F. Lynch, David J. Beausejour & David B. Casten, *Personal Goodwill: Three Recent Taxpayer Defeats Nevertheless Affirm Existence of a Sometimes Forgotten Asset*, 28 J. TAX’N INV. 29 (Winter 2011); Robert W. Wood, *The Emperor of Ice Cream, Dentists, and Personal Goodwill*, TAX NOTES TODAY, Nov. 15, 2010, available at LEXIS 2010 TNT 221-10; Robert W. Wood, *Personal Goodwill and the Emperor of Ice Cream*, M&A TAX REP., Oct. 2010, at 1. See also Jerome M. Schwartzman, *The Intangible Intangible: Increasing Value of a Deal Using Personal Goodwill*, J. CORP. TAX’N, Sept.–Oct. 2009, at 12 (detailing *Martin Ice Cream Co.* and other notions of personal goodwill).

for depreciation or amortization).³⁵ To provide certainty in this area, Congress enacted § 197 to generally allow all purchased intangible property, including goodwill, to be amortized over a fifteen-year period.³⁶ For purposes of § 197, the Treasury regulations promulgated under § 197 state that goodwill means “the value of a trade or business attributable to the expectancy of continued customer patronage” and “may be due to the name or reputation of a trade or business or any other factor.”³⁷ The regulations go on to distinguish goodwill from other intangible property including going concern value, customer based intangibles, trademarks and trade names, and workforce in place. However, for purposes of amortization, § 197 makes no significant distinction between these various intangible assets.

Although distinguishing between goodwill and other intangibles is no longer required for depreciation purposes due to the enactment of § 197, such distinctions are still relevant for transfer pricing purposes under § 482. Specifically, for transfer pricing purposes, an intangible asset constitutes either “residual goodwill” that is not a separate and distinct asset (from associated operating assets) and thus is not separately transferrable or, in the alternative, a “marketing intangible” that is categorized as a separate and distinct intangible asset (such as customer lists, know-how, customer reputation, and other similar items that are collectively known as “marketing intangibles” in the nomenclature used in § 482 cases) that can be segregated and separately disposed of as a separate and distinct item. However, as discussed further below, the creation, ownership, and transfer of a marketing intangible among related parties (such as in the context of

35. Prior to adoption of § 197, Treas. Reg. § 1.167(a)-3 (2011) provided that “No deduction for depreciation is allowable with respect to goodwill.” Accordingly, efforts to identify intangible property that was distinct from goodwill, and thus depreciable, led to substantial litigation.

36. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13261, 107 Stat. 312, 532-41.

37. Treas. Reg. § 1.197-2(b)(1) (2010). For some of the prior litigation over the question of what constituted goodwill, see, e.g., *Des Moines Gas Co. v. Des Moines*, 238 U.S. 153, 165 (1915) (describing goodwill as the aspect of a trade or business associated with the “fixed and favorable consideration of customers, arising from an established and well-known and well-conducted business”); *Newark Morning Ledger Co. v. United States*, 507 U.S. 546, 555-56 (1993) (favorably citing the quotation from *Des Moines Gas* and stating that the “shorthand description of goodwill as ‘the expectancy of continued patronage’ provides a useful label with which to identify the total of all the imponderable qualities that attract customers to the business”); *Metro. Nat’l Bank v. St. Louis Dispatch Co.*, 149 U.S. 436, 446 (1893) (quoting Justice Story’s definition of goodwill: “the advantage or benefit . . . from constant or habitual customers”); *Winn-Dixie Montgomery, Inc. v. United States*, 444 F.2d 677, 681 (5th Cir. 1971) (describing goodwill as the “expectancy that the old customers will resort to the old place”); *Houston Chronicle Publ’g Co. v. United States*, 481 F.2d 1240, 1247 (5th Cir. 1973) (favorably quoting *Winn-Dixie Montgomery*).

the **Example**) is subject to and governed by the transfer pricing rules of § 482.

In order for § 482 to apply in the context of the **Example**, the controlled C corporation and its controlling shareholder-employee must be engaged in two separate trades or businesses. The two-business requirement is readily satisfied if the shareholder-employee renders services not only to the controlled corporation but also in his or her personal capacity to unrelated third parties.³⁸ However, the majority of cases also hold that this two-business requirement is satisfied even if the shareholder-employee works exclusively for the controlled C corporation on the ground that the shareholder's business as an employee is separate from the business conducted by the controlled C corporation.³⁹

A divergent view on this issue was expressed in *Foglesong v. Commissioner*.⁴⁰ In *Foglesong*, the Seventh Circuit reversed the Tax Court's allocation of 98% of a personal service corporation's income that was allocated by the Internal Revenue Service (IRS) under § 482 to the controlling shareholder-employee. In its decision, the Seventh Circuit stated that the controlling shareholder had no other business and no other business assets apart from that of its controlled C corporation, and as a result the Seventh Circuit concluded that the two-business requirement of § 482 was not satisfied.⁴¹ However, in distin-

38. See, e.g., *Borge v. Comm'r*, 405 F.2d 673 (2d Cir. 1968); *Danica Enter., Inc. v. Comm'r*, 395 U.S. 933 (1969) (entertainer shifted part of his income to wholly owned corporation; reallocation upheld under I.R.C. § 482); see also Rev. Rul. 74-331, 1974-2 C.B. 282 (applying § 482 in closely-held context); Rev. Rul. 74-330, 1974-2 C.B. 278 (same).

39. See *Dolese v. Comm'r*, 811 F.2d 543 (10th Cir. 1987) (separate businesses found); *Rubin v. Comm'r*, 460 F.2d 1216 (2d Cir. 1972) (management services furnished to controlled corporation, which contracted services to third party for higher amount); *Ach v. Comm'r*, 358 F.2d 342 (6th Cir. 1966) (successful proprietorship transferred to corporation controlled by owner's son; portion of business profits allocated to transferor, who continued to manage enterprise); *Leavell v. Comm'r*, 104 T.C. 140 (1995) (100% allocation to earner under I.R.C. § 61 assignment of income doctrine); *Haag v. Comm'r*, 88 T.C. 604 (1987), *aff'd*, 855 F.2d 855 (8th Cir. 1988) (reallocation of income between corporation and shareholder-physician by reason of I.R.C. § 482); *Keller v. Comm'r*, 77 T.C. 1014, 1022 (1981), *aff'd*, 723 F.2d 58 (10th Cir. 1983) (applying I.R.C. § 482 but finding salary reasonable).

40. *Foglesong v. Comm'r*, 691 F.2d 848 (7th Cir. 1982).

41. This holding has been questioned as ill-conceived by several respected commentators. See Elliott Manning, *The Service Corporation—Who Is Taxable on Its Income: Reconciling Assignment of Income Principles, Section 482, and Section 351*, 37 U. Miami L. Rev. 657, 677 (1983); 1 BORIS I. BITTKER & JAMES EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶2.07[4] & ¶13.20[2][b] (7th ed. 2006 & Supp. 2011); 2 BORIS I. BITTKER & JAMES EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶¶13.20[2][b] (7th ed. 2006 & Supp. 2011); BORIS I. BITTKER, MARTIN J. McMAHON, JR., & LAWRENCE A. ZELENIAK, *FEDERAL INCOME TAXATION OF INDIVIDUALS* ¶37.02 (3d ed. 2011) (stating that the weight of authority is contrary); CYM LOWELL, PETER

guishing contrary authorities, the Seventh Circuit said the facts in *Foglesong* did not satisfy the two-business requirement of § 482 because “[b]y contrast, Foglesong transferred all of his business to the corporation and retained nothing.”⁴² In the context of the **Example**, the Shareholder is claiming that it did *not* transfer everything and instead **retained something**—most notably the shareholder-employee attempted to retain personal goodwill. In this context, the Shareholder in the **Example** claims that a separate shareholder-only asset exists and is peculiarly owned by the Shareholder and not by the controlled C corporation. It is at this point that the two-business requirement of § 482 has been satisfied even under the Seventh Circuit’s reasoning in *Foglesong*. Nevertheless, even with it said that § 482 appears applicable even under the reasoning set forth by the Seventh Circuit in *Foglesong*, the *Foglesong* rationale remains a minority view. The Tax Court refuses to follow *Foglesong* outside of the Seventh Circuit,⁴³ and the IRS refuses to follow it at all.⁴⁴ The implications of § 482 to the fact pattern set forth in the **Example** are set forth in section III.A.

Residual goodwill is not separately distinct from the underlying business to which it relates and thus cannot be sold independent of the operating assets of the business itself. This is why the § 482 regulations do not classify residual goodwill or going concern value as an intangible asset that is subject to transfer pricing analysis. Residual goodwill cannot be separated from the operating business assets.⁴⁵ Accordingly, when a business is conducted in a C corporation, any

BRIGER & MARK MARTIN, U.S. INTERNATIONAL TRANSFER PRICING ¶13.06 (WG&L 2011). The applicability of § 482 to closely-held corporations including personal service corporations has been discussed for many years. See John. E. Scheifly, *The Commissioner’s Attacks upon Personal Service Corporations*, in 19TH ANNUAL TUL. TAX INST. 336 (1970); Richard D. Hobbet, *The Corporate Entity: When Will It Be Recognized for Federal Tax Purposes?* 30 J. TAX’N 74 (1969); Stanton D. Rosenbaum, *Entertainer’s Corporations and Capital Gains*, 12 TAX L. REV. 33 (1956).

42. *Foglesong*, 691 F.2d at 852.

43. See, e.g., *Johnston v. Comm’r*, 80 T.C.M. 477 (2000).

44. Rev. Rul. 88-38, 1988-1 C.B. 246 (IRS states that it will not follow *Foglesong* on the applicability of I.R.C. § 482).

45. I.R.C. § 936(h)(3)(B) (Supp. 2010) (sets forth a list of separate and distinct intangibles independent of services and excludes residual goodwill from the list); Treas. Reg. § 1.482-4(b) (2010) (sets forth the same list as I.R.C. § 936 and states that this list of intangibles represents intangible property subject to I.R.C. § 482, but inseparable residual goodwill is excluded from the list); Treas. Reg. § 1.367(a)-1T(d)(5)(iii) (2011) (cross-references I.R.C. § 936(h)(3)(B)’s list of assets that are separate and distinct intangibles subject to I.R.C. § 367(d) but indicates that foreign goodwill and foreign going concern value are not subject to I.R.C. § 367(d) and that these items represent residual value after all separate and distinct assets have been identified and are inseparable from the business); Treas. Reg. § 1.367(a)-6T(c)(3) (2011) (confirms that residual goodwill resides with the business assets and is transferred with the business assets).

residual goodwill of the business resides with the business assets held by the C corporation and not with any other person. Similarly, when a business is conducted as a sole proprietorship, the residual goodwill is held by the sole proprietor but only as an integral part of the operating business assets. The authorities that discuss this issue are set forth below in section III.B.

The question presented in the **Example** is whether the personal goodwill can be maintained as a marketing intangible that the Shareholder can separately own and convey to another person or instead must be treated as residual goodwill held by the C corporation (or perhaps another item that is not separately transferrable by the Shareholder). The following discussion sets forth an analysis of the various permutations with respect to this question.

A. Marketing Intangibles

If a separate and distinct asset were found to factually exist in the fact pattern set forth in the **Example**, the courts would likely classify this separate and distinct intangible as a “marketing intangible.” In this regard, in *Eli Lilly & Co. v. Commissioner*⁴⁶ the Tax Court helped clarify the distinction between manufacturing intangibles, which were owned by a controlled subsidiary in that case, from marketing intangibles, which were owned by the US shareholder. In *Eli Lilly*, the Tax Court found that the marketing intangibles owned by Eli Lilly (the U.S. shareholder) included the trademarks for certain pharmaceutical compounds as well as the Lilly name and goodwill of the company. In describing the marketing intangible owned at the shareholder-level, the Tax Court said that Eli Lilly, as shareholder, enjoyed a favorable reputation in the marketplace and had developed a highly skilled marketing organization. The court found that this factual situation indicated that a marketing intangible existed at the parent-shareholder level and had significant value apart from the patents owned by the controlled manufacturing subsidiary. The Tax Court then stated that the marketing intangibles were owned by Eli Lilly because the costs to develop this market recognition, trade name, and customer goodwill had been funded entirely by Eli Lilly, the parent-shareholder, without reimbursement by the controlled manufacturing subsidiary.⁴⁷ Other courts have similarly held that marketing

46. 84 T.C. 996 (1985), *aff'd in part, rev'd on other grounds*, 856 F.2d 855 (7th Cir. 1988).

47. See also *GD Searle & Co. v. Comm'r*, 88 T.C. 252 (1987) (holding that transferred manufacturing intangibles had “little value” apart from the intangibles associated with the “marketing and administrative services” provided by Searle. The court then engaged in an effort to bifurcate the combined company goodwill between the manufacturing intangible owned by the manufacturing subsidiary and the marketing intangible owned by the distributor subsidiary). Arguably the

intangibles also can include customer lists, trademarks, trade names, brand names, and related customer goodwill,⁴⁸ and the government has asserted an even more expansive scope of situations where a marketing intangible might exist in its litigating positions.⁴⁹

Because marketing intangibles can be separately owned, controlled, and transferred, the creation and ultimate transfer of these intangibles are the subject of significant attention under § 482, as discussed more fully in the remainder of this section III.A.

1. *Transfer Pricing Rules*

The Treasury regulations under § 482 make clear that the financial benefits of “marketing intangibles” must be analyzed under a gauntlet of § 482 tests when these intangibles are created by related parties.⁵⁰ Thus, in order to determine whether the allocation set forth in the **Example** will be respected, it is necessary to analyze how § 482 would impact the tax planning posited in the **Example**.

highest profile contest involving a marketing intangible was *GlaxoSmithKline Holdings (Americas), Inc. v. Comm’r*, T.C. Nos. 5750-04 and 6959-05, where the IRS assessed a \$4.6 billion tax deficiency against the U.S. distribution subsidiary of a U.K.-based pharmaceutical manufacturer based on the purported value of marketing intangibles developed and used by the subsidiary. The case was ultimately settled prior to trial. I.R.S. News Release IR-2006-142 (Sept. 11, 2006).

48. See, e.g., *Clarke v. Haberle Crystol Springs Brewing Co.*, 280 US 384 (1930) (goodwill in the nature of trademarks, trade names and trade brands); *JC Cornillie Co. v. United States*, 298 F. Supp. 887 (E.D. Mich. 1968) (goodwill in the form of customer lists); and *Drybrough v. Comm’r*, 45 T.C. 424 (1966), *aff’d*, 384 F.2d 715 (6th Cir. 1967) (goodwill consisting of agency’s file of uncollected claims). See also I.R.S. Priv. Ltr. Rul. 8134193 (May 29, 1981) (defining “marketing intangibles” as the right to use tradename, trademark, and related goodwill).
49. The IRS has taken an expansive view of what constitutes an intangible in several instances. See FSA 200230001 (project finance developer’s efforts to negotiate a comprehensive package of interdependent contracts to finance, construct, and operate a project constituted an intangible asset). Arguably, FSA 200230001 is inconsistent with the result reached in *Hosp. Corp. of Am., Inc. v. Comm’r*, 81 T.C. 520 (1985), nonacq. in part 1987-2 C.B. 1, where the Tax Court rejected the IRS’s characterization of the negotiation of the terms of a hospital management contract as a transfer of property on the grounds that what was provided by the taxpayer did not represent a legally enforceable right and was, at best, merely a business opportunity. See also I.R.S. Tech. Adv. Mem. 200907024 (Feb. 13, 2009) (stating that a network of contracts with independent foreign agents constitutes intangible asset apart from goodwill for purposes of § 367(d)); *Merck & Co. v. United States*, 24 Cl. Ct. 73 (1991) (showing that the government argued unsuccessfully that the taxpayer’s strategic planning structure and system of intercompany pricing were services requiring an arm’s-length payment from the subsidiary to the taxpayer).
50. See, e.g., Treas. Reg. § 1.482-1(d)(3)(ii)(C) (Ex. 4) (2010) (example posits a case involving “marketing intangibles”); see also 1988 White Paper, Notice 88-123, 1988-2 CB 458, 497 (stating that the I.R.C. § 936 definition of intangible property, which is identical to the definition contained in I.R.C. § 482, includes marketing intangibles).

The first inquiry to be made under the final Treasury regulations promulgated under § 482 is to determine whether the intangible has “substantial value *independent* of the services of any individual.”⁵¹ If not, then no separate marketing intangibles will be respected and valued for US tax purposes.⁵² Thus, when controlling shareholders have provided ongoing services to their controlled C corporation, the shareholders must demonstrate that the results of these personal services are the creation of a marketing intangible containing significant value independent of the services performed on behalf of the controlled C corporation and by necessity that the cash compensation paid to the Shareholder was inadequate.⁵³ If not, then whatever intangible value is created as a result of the shareholders’ services inures to the benefit of the service recipient, namely the controlled C corporation, i.e., the C corporation in the **Example**.

The above approach is consistent with prior judicial decisions. In this regard, in *Medieval Attractions, N.V. v. Commissioner*,⁵⁴ the Tax

51. Treas. Reg. § 1.482-4(b) (2010) (emphasis added).

52. *See id.*; *see also* Seagate Tech., Inc. v. Comm’r, 102 T.C. 149 (1994) (finding a distinction between marketing intangibles for which a royalty was charged and increased under § 482 by the court, and marketing services provided under a “Marketing Agreement”).

53. *See* Veritas Software Corp. v. Comm’r, 133 T.C. 297 (2009). This case primarily addressed a cost sharing buy-in payment, but the Tax Court found no evidence to support a finding that the transfer of access to U.S. based R&D and marketing teams was the transfer of an intangible. As part of this discussion, the court included the following in a footnote:

Even if such evidence existed, these items would not be taken into account in calculating the requisite buy-in payment because they do not have “substantial value independent of the services of any individual” and thus do not meet the requirements of § 936(h)(3)(B) or § 1.482-4(b), Income Tax Regs. “Access to research and development team” and “access to marketing team” are not set forth in § 936(h)(3)(B) or § 1.482-4(b), Income Tax Regs. Therefore, to be considered intangible property for § 482 purposes, each item must meet the definition of a “similar item” and have “substantial value independent of the services of any individual.” § 936(h)(3)(B); § 1.482-4(b), Income Tax Regs. The value, if any, of access to VERITAS US’ R&D and marketing teams is based primarily on the services of individuals (i.e., the work, knowledge, and skills of team members). Nevertheless, respondent in support of his contention cites *Newark Morning Ledger Co. v. United States*, 507 U.S. 546 (1993), and *Ithaca Indus., Inc. v. Commissioner*, 97 T.C. 253 (1991), *affd.* 17 F.3d 684 (4th Cir. 1994). These cases, however, do not suggest that access to an R&D or marketing team has substantial value independent of the services of an individual, do not define intangibles for § 482 purposes, and do not even reference § 482. We note that in December 2008, the Secretary promulgated temporary regulations (i.e., secs. 1.482-1T through 1.482-9T, Temporary Income Tax Regs., *supra*) which reference “assembled workforce.” In addition, the administration, in 2009, proposed to change the law to include “workforce in place” in the § 482 definition of intangible.

Veritas, 133 T.C. at 323 n.31.

54. *Medieval Attractions, N.V. v. Comm’r*, 72 T.C.M. 924 (CCH) (T.C. 1996) .

Court held that the taxpayer, a newly created U.S. operating subsidiary, owned the name and concept behind its entertainment package and therefore could not deduct franchise and royalty payments made to its foreign shareholder. Even though the idea for a medieval entertainment facility and show could be traced back to one of the ultimate foreign shareholders and the relevant trademark and copyright registrations were filed in the name of the foreign shareholder, the Tax Court found several deficiencies. The concept of a medieval entertainment program was not subject to legal protection, the name used in connection with the taxpayer's program was the taxpayer's name, the specific entertainment package used by the taxpayer was developed and modified by the taxpayer's employees and funded by the taxpayer, and the trademark and copyright registrations were undertaken after the fact in connection with tax advice. Thus, the court found that there was no separately created intangible warranting separate economic value to be paid to the foreign shareholder.⁵⁵

The above restriction would seem to be a significant restriction in the fact pattern set forth in the **Example**. The Shareholder's ongoing business development activities in the **Example** are intrinsically linked to the personal services performed for the corporation. The services in the **Example** arguably represent routine marketing, development, and advertising services. In this fact pattern, where the C corporation bears the cost of these services from inception, the Shareholder should have the burden to demonstrate that the Shareholder's activities created a significant intangible somehow independent of the services provided to and paid for by the corporation. In the event that the Shareholder in the **Example** was unable to meet this burden, the goodwill attendant with the favorable business reputation belongs to the C corporation in the **Example**.⁵⁶

However, even assuming that the Shareholder were able to sustain this factual burden and demonstrate that a significant marketing intangible with value independent of the services the shareholder provided to the C corporation does in fact exist, the inquiry then shifts to the question of which person (the shareholder or C corporation) is entitled to receive the financial benefit arising from the marketing intangible.

As an initial matter in the case of legally protected intangibles, the final regulations under § 482 confirm that the legal ownership of intangibles will be respected so long as the legal ownership of the intangible has economic substance.⁵⁷ In several cases discussed in section

55. *Id.*

56. The authorities discussing the inseparability of residual goodwill from the overall business assets are set forth *infra* section III.B.

57. See Treas. Reg. § 1.482-4(f)(3). The preamble to the proposed regulations preceding the final regulations makes clear that this aspect of the regulations was in

III.B., taxpayers have attempted to make much of the fact that no contractual ownership rights existed that could be deemed to have been transferred by the shareholder to the controlled C corporation. And, in the **Example**, it is posited that no employment agreement exists. However, the § 482 regulations provide the IRS with authority to deem the existence of such a contractual relationship if that better accords with the economic substance of the arrangement,⁵⁸ and this would appear to be the case if the C corporation has borne the marketing, advertising, client development, and business development expenses. Given the expansive scope set forth in the final regulations for recasting the tax ownership of a marketing intangible away from the true legal owner when such owner did not bear the cost or expense of creating the intangible or was fully reimbursed for its creation, this aspect of the § 482 regulations creates significant authority for the IRS to disregard the shareholder's purported legal ownership in the **Example**. The reason is that even though no licensing agreements or other contractual arrangements were put in place with respect to the marketing intangible in the **Example**, the C corporation funded the cost that created and enhanced the value of the intangible, and, as a consequence, it became the economic owner of the intangible.

Moreover, the final regulations provide an entirely different approach for intangibles, including marketing intangibles, that are not legally protected or exist under circumstances in which the true legal owner is unclear. In such a situation, the § 482 regulations treat the party that has practical "control" over the intangible as the sole owner.⁵⁹ The § 482 regulations provide an example to illustrate this alternative where the ownership of the intangible was unclear but where the licensee of a trademark bore the cost associated with developing the list of customers that regularly purchased goods marketed under the trademark.⁶⁰ In this Example 2, it is assumed that intellectual property law did not specify whether the licensor or the licensee was the owner of the list. Because the licensee—which is in the same posture as the C corporation in the **Example**—has knowledge of the

response to criticism of the 1994 regulations' ownership rule as inconsistent with intellectual property law and general tax principles for determining ownership. T.D. 9278, 2006-2 C.B. 256.

58. Treas. Reg. § 1.482-1(d)(3)(ii)(B)(1).

59. Treas. Reg. § 1.482-4(f)(3)(i)(A). The final regulations' determination to look at effective control over an intangible is a departure from the 1994 regulations' approach of looking to the party who bore the largest portion of the development costs as the owner of the intangible. For the reasons discussed in the text accompanying notes 57–60, the determination of legal ownership is not determinative of how the economic benefit of the marketing intangible ultimately will be allocated among related parties.

60. See Treas. Reg. § 1.482-4(f)(3)(ii) Ex.2.

contents of the list and has practical control over its use and dissemination, the licensee, not the licensor, is treated as the sole owner.⁶¹

Example 2 would seem troublesome in many of the actual cases that would exist in the personal goodwill context. In the situation set forth in the **Example**, the self-created marketing intangible is not legally protected as between the C corporation and its shareholder. In this situation, because the C corporation (the “licensee” in the context of Example 2) has control over the use and results of the marketing intangible and because the shareholder’s legal protection of the marketing intangible vis-à-vis the C corporation is arguably unclear, the regulations state that the C corporation in this situation shall be considered the tax owner of the intangible. The critical elements for this inquiry are the C corporation’s practical control and knowledge of the customer list, customers, and business development strategies. Unless shareholders can demonstrate they have legal protection for their rights in the marketing intangibles vis-à-vis the C corporation, Example 2 of the § 482 regulations provides a difficult hurdle to overcome.

However, even if one assumes the unlikely scenario that the Shareholder in the **Example** can demonstrate that a marketing intangible independent of the personal services was created and that this marketing intangible is owned by the Shareholder under the analysis required by Treas. Reg. § 1.482-4(f)(3), the issue remains whether the shareholder is entitled to income generated from the intangible.⁶² This will be determined by the application of Treas. Reg. § 1.482-4(f)(4), discussed *infra*, which establishes a separate and distinct requirement in the § 482 regulations. Its purpose is to prevent a situation where the tax ownership was determined to be with one related party and this determination resulted in an “inappropriate all-or-nothing result[.]” based solely on the determination of ownership.⁶³ Thus, Treas. Reg. § 1.482-4(f)(4)(i) explicitly reallocates the economic benefit of an intangible, including a marketing intangible, away from the legal owner of the intangible by stating that the legal owner must compensate the affiliate for any enhancement in value attributable to the affiliate’s participation.

Treas. Reg. § 1.482-1(f)(4)(ii)(C), Example 5 illustrates the application of Treas. Reg. § 1.482-4(f)(4) in the context of a hypothetical

61. *Id.*

62. In many of the personal goodwill cases, taxpayers have attempted to argue that an intangible is owned by the shareholder and simply assume that meeting this standard ends the analysis. See Brief of Appellant at Howard v. United States, No. 10-35768 (9th Cir. Sept. 1, 2010) (“Professional, human, goodwill is that of a human. Not an entity. In Washington, and in all states, professional goodwill is a personal asset.”). As more fully discussed below in the text, the existing transfer pricing regulations have explicitly rejected this approach as set forth in the preamble to the final regulations. See *infra* p. 24 and note 65.

63. T.D. 9278, 2006-2 C.B. 256, 268.

closely analogous to the **Example**. In this regard, Example 5 posits a situation where trademarks are registered in the name of the legal owner/foreign shareholder but the controlled C corporation incurs costs associated with advertising to promote the foreign-owned trademark in the United States. The regulatory example explains that the controlled C corporation's funding of the advertising and promotion activities that enhance the value of the foreign shareholder's separately-owned marketing intangible was inconsistent with the registration of the legal ownership in the created intangible in the legal owner's name. Thus, Example 5 makes clear that the affiliated entity bearing responsibility for the enhancing the value of the owner's marketing intangible must receive an appropriate arm's-length return.

The preamble to the regulations further clarifies Example 5 by stating that it is a longstanding principle under Treas. Reg. §1.482-4(d)(1) that the Commissioner may consider reasonable alternatives in its determination of the arm's length valuation of the controlled transaction if a realistic alternative would create a greater § 482 allocation.⁶⁴ The preamble to the final regulations provides that if a related party's realistic alternative appears preferable in comparison to the price associated with the taxpayer's chosen legal form, the logical implication is that the taxpayer's legal arrangement has been priced incorrectly.⁶⁵ Furthermore, in determining the appropriate profit margin for the controlled C corporation when it has enhanced the value of an affiliate's marketing intangible, the final regulations incorporate the "commensurate with income" test of § 367(d). When this test is applied to the controlled C corporation in the **Example**, the C corporation must receive an economic benefit commensurate with the actual benefits associated with the enhancement of value of the marketing intangible.⁶⁶ Thus, given that the "commensurate with in-

64. See T.D. 9456 (August 4, 2009).

65. See Treas. Reg. §1.482-9(a) (2010); T.D. 9456 (August 4, 2009). In the 2003 proposed regulations, one of the examples concluded that "[i]f it is not possible to identify uncontrolled transactions that incorporate a similar range of interrelated elements and there are nonroutine contributions by each of [the controlled parties], then the most reliable measure of the arm's-length price . . . may be the residual profit split method." Prop. Treas. Reg. § 1.482-4(f)(4)(ii) Ex. 2, 68 Fed. Reg. 53,448, 53,463 (Sept. 10, 2003). This endorsement of the residual profit split method elicited objections from commentators because the examples suggested that the residual profit split method was the preferred method if it were not possible to identify uncontrolled transactions with a similar range of interrelated elements. In response, the preamble to the temporary regulations indicates that the Treasury and the IRS did not intend to imply that the residual profit-split method was the preferred method for cases involving a non-owner contribution. 2006-2 C.B. at 268. As a result, explicit references to the residual profit-split method have been replaced in the 2006 temporary regulations and the 2009 final regulations by a general reference to the best-method rule. See, e.g., Treas. Reg. § 1.482-4(f)(4)(ii) Ex. 3 (2010).

66. Treas. Reg. § 1.482-4(f)(2)(i).

come” test is applicable to this valuation inquiry, the IRS is authorized to consider the ultimate disposition value of the goodwill to the subsequent buyer in the **Example** for purposes of determining whether the controlled C corporation has received an adequate allocation of that overall value attributable to the costs incurred by it that enhanced the value of the marketing intangible.

The implications of these regulations are significant for the personal goodwill inquiry. Even if the Shareholder in the **Example** were able to claim that the shareholder owned a marketing intangible, the economic benefits of this intangible nevertheless would be allocated away from the shareholder (i.e., away from the legal owner) and to the C corporation by reason of Treas. Reg. § 1.482-4(f)(4). This is because the economic relationship between them demonstrates that the C corporation was the party bearing the risk and expense of funding the development and enhancement in value of the marketing intangible. Accordingly, the C corporation is entitled to be compensated for its contribution toward the creation and enhancement of the value of the marketing intangible. Given that the C corporation paid the costs of the marketing intangible and given the “look-back” aspects of the commensurate with income test, the economic benefit of the enhancement in the value of the Shareholder’s marketing intangible must be allocated back to the C corporation in the **Example**. As a result, in the context of the **Example**, it is unlikely that any economic benefit would remain in the hands of the shareholder due to the requirements of Treas. Reg. §1.482-4(f)(4).

2. *Martin Ice Cream*

The principal authority referenced by proponents of the personal goodwill planning technique is the Tax Court decision in *Martin Ice Cream*,⁶⁷ which involved an analysis of the tax consequences associated with a distribution of property by a corporation, Martin Ice Cream, to its shareholder, Arnold Strassberg. Given the analysis now required by the regulations promulgated under § 482, the dicta in *Martin Ice Cream* that may suggest that the economic value of a shareholder-level marketing intangible remains entirely allocable to the shareholder under the case’s facts has doubtful continued validity for several reasons.

In *Martin Ice Cream*, the IRS audited Martin Ice Cream’s 1988 corporate tax return and proposed an adjustment on the grounds that Martin Ice Cream recognized a taxable gain of \$1,430,340 on the distribution of the stock of its subsidiary, Strassberg Ice Cream Distribution, to Arnold Strassberg as part of a failed § 355 split-off. Additionally, the IRS alleged that the sale of assets by Arnold Strass-

67. *Martin Ice Cream v. Comm’r*, 110 T.C. 189 (1998).

berg to a third party should be attributed to Martin Ice Cream under the *Court Holding* doctrine.⁶⁸

Arnold Strassberg, a high school math teacher who began moonlighting soon after the end of World War II by selling ice cream products wholesale to stores in Newark, New Jersey, revolutionized the way in which ice cream is marketed and sold. He initially conducted his activities as a sole proprietor and later organized a corporation through which he conducted the business. However, he was forced to put that corporation through bankruptcy in the late 1960s.

In 1971, his son, Martin Strassberg, followed in his footsteps and organized Martin Ice Cream to conduct an ice cream distribution business. Martin was the sole shareholder of Martin Ice Cream and conducted its activities on a part-time basis with help from Arnold until 1975, when Martin began working full-time in the business.

In 1974, Mr. Mattus, the founder of Haagen-Dazs, asked Arnold to market its ice cream products to supermarkets. Arnold's work for Haagen-Dazs revolutionized ice cream marketing and the retail sale of ice cream products. He was so good that Mr. Mattus invited him to become his partner for the expansion of Haagen-Dazs to the West Coast. However, Arnold declined the offer and chose to remain with Martin Ice Cream. In 1979, Arnold became a 51% owner of Martin Ice Cream with Martin retaining ownership of the remaining 49% of the company.

Martin Ice Cream was a distributor of Haagen-Dazs products. However, with no written distribution agreement with Haagen-Dazs, all business was conducted on the basis of an oral agreement between Arnold and Mr. Mattus. In 1983, Haagen-Dazs was acquired by another company, which changed the business plan for Haagen-Dazs and decided that all oral distribution agreements with Haagen-Dazs required termination. As a result, Haagen-Dazs approached Arnold about acquiring his relationships with supermarkets.

About this time, Arnold and Martin decided they no longer wished to work together and took advantage of the discussions with Haagen-Dazs to restructure their affairs so they could go their separate ways. To that end, Strassberg Ice Cream Distribution was organized in 1988 as a subsidiary of Martin Ice Cream, and documents were executed pursuant to which Martin Ice Cream conveyed to Strassberg Ice Cream Distribution all of its Haagen-Dazs distribution rights. Thereafter, Martin Ice Cream distributed the stock of Strassberg Ice Cream Distribution to Arnold in redemption of all of his shares of stock in

68. *Id.* at 211-14. This refers to the Supreme Court's holding in *Commissioner v. Court Holding*, 324 U.S. 331 (1945), which generally contemplates that the substance of negotiations will determine tax consequences and that last minute changes to form and structure for a transaction may not be respected if done merely to achieve tax planning objectives.

Martin Ice Cream in a transaction that they intended to constitute a tax-deferred split-off under § 355.

Following the split-off transaction, Arnold and Strassberg Ice Cream Distribution closed a transaction in 1988 pursuant to which Haagen-Dazs purchased from them all of their Haagen-Dazs distribution rights. The purchase price was \$1,430,340 (following an audit adjustment, and disregarding a contingent amount to be paid over subsequent years). This amount was the basis for the IRS contention that Martin Ice Cream recognized a \$1,430,340 gain from the split-off transaction. The history of the relationship and negotiations with Haagen-Dazs also supported the IRS contention that the *Court Holding* doctrine should be applied to attribute the transaction with Haagen-Dazs to Martin Ice Cream.

The Tax Court started its analysis by finding that Martin Ice Cream never owned the personal relationships Arnold had developed with customers or Haagen-Dazs, which began long before either Martin Ice Cream or Strassberg Ice Cream Distribution were organized. The Tax Court reviewed Arnold's many accomplishments and leadership in the field of ice cream marketing and described the foregoing personal relationships as "intangible assets."⁶⁹ The Tax Court next found that Arnold retained ownership of the intangible assets, stating that:

Ownership of these intangible assets cannot be attributed to petitioner [Martin Ice Cream] because Arnold never entered into a covenant not to compete with petitioner or any other agreement—not even an employment agreement—by which any of Arnold's distribution agreements with Mr. Mattus, Arnold's relationships with the supermarkets, and Arnold's ice cream distribution expertise became the property of petitioner. This Court has long recognized that personal relationships of a shareholder-employee are not corporate assets when the employee has no employment contract with the corporation. Those personal assets are entirely distinct from the intangible corporate asset of corporate goodwill.⁷⁰

The Tax Court then concluded that "the sale to Haagen-Dazs of Arnold's supermarket relationships and distribution rights cannot be attributed to petitioner."⁷¹

The Tax Court then went on to analyze the actual issue presented by the case, which was the tax consequences to Martin Ice Cream from the redemption transaction. The Tax Court quickly concluded that the redemption transaction did not satisfy the requirements of § 355 because Strassberg Ice Cream Distribution was not engaged in the active conduct of a trade or business immediately after the transaction.⁷² As a result, the redemption transaction was taxable under

69. *Martin Ice Cream*, 110 T.C. at 206.

70. *Id.* at 207.

71. *Id.* at 209.

72. *Id.* at 217.

§ 311(b).⁷³ The Tax Court then analyzed the amount of gain that was required to be recognized from the transaction. Based on the conclusion that Martin Ice Cream never owned the assets related to Haagen-Dazs that were later sold by Arnold, the Tax Court concluded that the value was substantially less than what the IRS had argued.

The Tax Court's reference to Arnold's ownership of the intangible assets appears to be the principal focus of the proponents of the personal goodwill planning technique. However, the Tax Court in *Martin Ice Cream* did not address the tax consequences to Arnold and Strassberg Ice Cream Distribution from their transaction with Haagen-Dazs. As a result, the Tax Court in *Martin Ice Cream* did not conclude that Arnold owned a capital asset for tax purposes in the form of personal goodwill, let alone that he sold a capital asset for tax purposes in the form of personal goodwill.⁷⁴ It merely concluded that Martin Ice Cream did not have any intangible assets or goodwill attributable to Haagen-Dazs or Arnold's skills and abilities. As discussed in section III.B., *infra*, this does not mean that Arnold owned anything that should be considered in the nature of transferrable "goodwill," that is to say personal goodwill. The Tax Court in *Martin Ice Cream* simply did not go that far.⁷⁵

In *Kennedy v. Commissioner*,⁷⁶ the Tax Court reviewed *Martin Ice Cream* and explained its holding in that case in the following manner:

But the Court in *Martin Ice Cream Co.* had no occasion to address how the shareholder should be taxed on the payments, inasmuch as the shareholder had no case before the Court. Therefore, the Court was not called to opine on whether the payments should be treated as payments for services or payments for a capital asset.⁷⁷

It seems clear from this statement that the Tax Court does not consider *Martin Ice Cream* as standing for the broad proposition that any personal goodwill or marketing intangible existing in the hands of Ar-

73. Because Martin Ice Cream elected to be taxed as an S corporation prior to January 1, 1987 (even though the change was not effective until November 1, 1987), it was subject to the "built-in gains tax" then in effect under § 1374 of the Code with respect to the redemption transaction. *Id.* at 229. As a result, the redemption transaction was taxable to both Martin Ice Cream and Martin Strassberg (i.e., Arnold's son and the sole shareholder of Martin Ice Cream following the redemption transaction).

74. *See id.* at 209–10; *Kennedy v. Comm'r*, 100 T.C.M. (RIA) 268, 275 (2010) (applying this limited reading of the holding in *Martin Ice Cream*).

75. In fact, the Tax Court cited *Providence Mill Supply Co.*, discussed *infra*, favorably, which was a case that stated personal skills and abilities do not constitute an item of goodwill that is subject to transfer. *See Providence Mill Supply Co. v. Comm'r*, 2 B.T.A. 791 (1925) (the taxpayer in *Providence* was a corporation trying to reduce its tax for 1919 and 1920 on the grounds that it acquired goodwill from its founding shareholder as a contribution to capital).

76. *Kennedy*, 100 T.C.M. (CCH) at 268.

77. *Id.* at 275.

nold constituted a capital asset that could be sold by Arnold for tax purposes.

It is interesting, perhaps remarkable, that the IRS did not raise any of the § 482 regulations noted above to make its case in *Martin Ice Cream*. While our discussion focuses on the 2009 regulations, which antedated *Martin Ice Cream*, similar concepts existed in the applicable regulations that existed at that time. In any event, in light of the current § 482 regulations, if in fact Arnold did hold a marketing intangible, several aspects of the *Martin Ice Cream* opinion would raise interesting issues under current law. First, the Tax Court in *Martin Ice Cream* made an ultimate finding of fact that the “sole owner” of the intangible assets, i.e., a marketing intangible, was the shareholder, Arnold, and not Martin Ice Cream, the controlled corporation.⁷⁸ This would be a problematic finding under the § 482 regulations which, as indicated *supra*, were promulgated after the years at issue in *Martin Ice Cream*. The controlled corporation, Martin Ice Cream, had practical access to the marketing intangible and knowledge of how to exploit it. The record is also unclear whether the shareholder, Arnold, could have prevented the controlled corporation, Martin Ice Cream, from using the customer list and customer contacts after the disposition of the business. Given this uncertainty over the legal protection that Arnold had vis-à-vis the controlled corporation, Treas. Reg. § 1.482-4(f)(3) arguably could require a finding that Martin Ice Cream, not Arnold, was in fact the sole owner of this marketing intangible.

A second issue with the Tax Court’s reasoning in *Martin Ice Cream* relates to the court’s holding that the entire economic benefit of the intangible asset was allocable to Arnold because Arnold was considered the sole owner of the intangible. This “all or nothing approach” is what the preamble to the final regulations explicitly attempted to forestall in Treas. Reg. § 1.482-4(f)(4). Under the analysis now required under Treas. Reg. § 1.482-4(f)(4), Martin Ice Cream would be allocated a portion of the “shareholder-owned goodwill” to the extent it funded the expenditures that enhanced the value of the shareholder’s, i.e., Arnold’s, marketing intangible. Furthermore, the economic benefit that is appropriate for Martin Ice Cream to receive is governed by the “commensurate with income” rules of Treas. Reg. § 1.482-4(f)(2). Accordingly, the IRS would be able to consider the ultimate dispositional value of the goodwill at the time of its sale in its analysis of determining what portion of the economic benefits of the shareholder-owned intangible should have been allocated to Martin Ice Cream and away from Arnold. As a result, *Martin Ice Cream* would not seem to provide much support for the Shareholder’s proposition in the **Example**.

78. See *Martin Ice Cream*, 110 T.C. at 206.

Notwithstanding the foregoing, there is one important distinction between the facts in *Martin Ice Cream* and those set forth in the **Example** that deserves further consideration. In this regard, Arnold arguably had a self-created intangible prior to the formation of Martin Ice Cream given that his customer relationship pre-dated the formation of the company. Thus, unlike the case posited in the **Example**, Arnold is entitled to receive the economic benefits associated with the value of this pre-existing intangible since Arnold originally created it. However, existing case law would indicate that the value of customer relationships deteriorates over time. On the facts set forth in *Martin Ice Cream*, it appears that Arnold continued to maintain his customer contacts and business relationships for nine years after he became a shareholder of Martin Ice Cream. If Martin Ice Cream bore the entertainment expenses, marketing expenses, and business development expenses related to these customer contacts for such years and paid Arnold a salary for his efforts—albeit no employment agreement existed—then the value of the marketing intangible may be owned by Martin Ice Cream outright. Alternatively, such value would at least need to be bifurcated between the value attributable to the pre-shareholder customer contacts and the value attributable to the ongoing customer-related efforts that occurred over the nine years after he became a shareholder. Cases such as *Newark Morning Ledger*⁷⁹ indicate that the value of customer list and customer goodwill deteriorate, so as of 1988 the value of the marketing intangible in *Martin Ice Cream* was likely attributable to the ongoing customer contacts made over the nine years after Arnold became a shareholder of Martin Ice Cream, at a time when Martin Ice Cream began funding these expenditures. As a result, very little of the value may be attributable to the contacts and expenditures made a decade earlier before he became a shareholder. If so, then proportionately little of the economic benefit of the intangibles would be allocated to Arnold as compared to Martin Ice Cream under Treas. Reg. § 1.482-4(f)(4) even if Arnold were the sole legal owner of this intangible, which itself is a doubtful conclusion given the stringent analysis required under Treas. Reg. § 1.482-4(f)(3).

3. *Taxpayer Duty of Consistency*

In general, advertising and marketing costs are currently deductible even though they may create valuable marketing intangibles.⁸⁰

79. *Newark Morning Ledger Co. v. United States*, 734 F. Supp. 176 (D. N.J. 1990), *rev'd*, 945 F.2d 555 (3d Cir. 1991), *rev'd*, 507 U.S. 546 (1993) (reinstating the district court decision that ascertained the depreciable life of customer Sunday subscriptions lists as 14.7 years as to one list and 23.4 years as to a second list).

80. *See* *Denise Coal Co. v. Comm'r*, 29 T.C. 528 (1957); Rev. Rul. 92-80, 1992-2 C.B. 57 ("The INDOPCO decision does not affect the treatment of advertising costs under § 162(a) of the Code. These costs are generally deductible under that sec-

Similarly, taxpayers generally are able to currently deduct pre-operating expenditures that create or improve the "going concern value" of an enterprise.⁸¹ Taxpayers have also achieved success in deducting costs associated with expanding an existing business.⁸² Congress has considered requiring capitalization of these costs that result in self-created intangibles, but it has never moved forward with those reform proposals.⁸³ In addition, even after the broadly worded opinion in *Indopco, Inc. v. Commissioner*,⁸⁴ the IRS has continued to accept that marketing costs generally need not be capitalized even though they may create or enhance the intangible assets of the corporation.⁸⁵

tion even though advertising may have some future effect on business activities, as in the case of institutional or goodwill advertising"); Rev. Rul. 68-561, 1968-2 C.B. 117.

81. See I.R.C. § 195 (2006); see also S. REP. NO. 96-1036, at 12 (1980) ("In the case of an existing business, eligible startup expenditures do not include deductible ordinary and necessary business expenses paid or incurred in connection with an expansion of the business. As under present law, these expenses will continue to be currently deductible.").
82. See, e.g., *Briarcliff Candy Corp. v. Comm'r*, 475 F.2d 775 (2d Cir. 1973); *NCNB Corp. v. United States*, 684 F.2d 285 (4th Cir. 1982); *Cent. Texas Savings & Loan Ass'n v. Comm'r*, 731 F.2d 1181 (5th Cir. 1984); *Iowa-Des Moines Nat'l Bank v. Comm'r*, 592 F.2d 433 (8th Cir. 1979); *Colorado Springs Nat'l Bank v. United States*, 505 F.2d 1185 (10th Cir. 1974); *First Sec. Bank v. Comm'r*, 334 F.2d 120 (9th Cir. 1979).
83. Compare H.R. REP. NO. 103-111, at 760 (1993) (legislative history to § 197 simply states that "[i]t is also believed that there is no need at this time to change the Federal income tax treatment of self-created intangible assets, such as goodwill that is created through advertising and other similar expenditures"), with STAFF OF J. COMM. ON TAX'N, 104TH CONG., IMPACT ON SMALL BUSINESS OF REPLACING THE FED. INCOME TAX 83 (J. Comm. Print 1996), <http://www.jct.gov/publications.html?func=startdown&id=2183> (Capitalizing and then amortizing 20% of advertising costs was estimated to increase tax revenues by \$37.9 billion in 1987), and Tax Analysts, *Revenue Options Book Released but Is It a Best Seller?*, TAX NOTES TODAY, June 29, 1987, available at LEXIS, 87 TNT 125-1, and Alexander Polinsky, *Amortizing Advertising Expenses: Not in the Foreseeable Future*, TAX NOTES TODAY, Sept. 27, 1993, available at LEXIS, 93 TNT 199-2. ("revenues would increase by more than \$18 billion over five years in 1993"). The pressure of group opposition to capitalization of advertising costs is even more substantial. See Polinsky, *supra*; Barbara Kirchheimer, *Proposal to Capitalize Advertising Expenses Draus Fire at W&M Revenue Hearing*, TAX NOTES TODAY, Sept. 5, 1993, available at LEXIS 93 TNT 187-1; STAFF OF J. COMM. ON TAX'N, 103d CONG., DESCRIPTION OF MISC. REVENUE PROPOSALS SCHEDULED FOR A HEARING BEFORE THE SUBCOMM. ON SELECT REVENUE MEASURES OF THE H. COMM. ON WAYS AND MEANS ON SEPT. 8, 21, AND 23, 1993 and THE H. COMM. ON WAYS AND MEANS ON SEPT. 9, 1993, Proposal II.B.3, (J. Comm. Print 1993), reprinted in TAX NOTES TODAY, Sept. 20, 1993.
84. *Indopco, Inc. v. Comm'r*, 503 U.S. 79 (1992).
85. See, e.g., Rev. Rul. 2000-4, 2000-1 C.B. 3314 (costs to obtain ISO 9000 certification currently deductible notwithstanding decision in *Indopco*); Rev. Rul. 96-62, 1996-2 C.B. 9 (employee training costs deductible notwithstanding decision in *Indopco*); Rev. Rul. 92-80, 1992-2 C.B. 57 (advertising costs currently deductible notwithstanding decision in *Indopco*).

Given these rules, it is likely that the development and customer related costs in the **Example** would have been deducted on the C corporation's tax return as ordinary and necessary business expenses directly related to the business of the C corporation. In order to claim that these expenditures were ordinary and necessary business expenses under § 162, the implicit representation is that these expenses were directly incurred for the benefit of the C corporation and were not for the benefit of the shareholder.⁸⁶ Thus, the C corporation has taken a position with respect to the fact that the C corporation is the direct beneficiary of the expenditures incurred in the **Example**.

Furthermore, by not reporting income in the amount of the increase in value of the marketing intangible in prior years when the development and customer related costs were incurred, the Shareholder in like manner has also made a prior representation that the Shareholder was not the recipient of any intangible value creation in the earlier tax periods. In this regard, if the marketing expenses are borne by the C corporation and the results of these marketing and customer development expenditures creates a separate marketing intangible that is owned by the related-party shareholder, then Treas. Reg. § 1.482-4(d)(4)(i) provides that the owner of the separately created marketing intangible must compensate the affiliate for this marketing intangible on an arm's length basis. Because the costs associated with creating the marketing intangible must be reimbursed when created for the benefit of an affiliate, the deduction in full for such costs on the C corporation's tax return without reimbursement by the shareholder could constitute a representation of fact that the C corporation was the direct beneficiary of this expenditure and also a representation of law that no marketing intangible of any significant value was created for the benefit of the related party shareholder. The implications are significant. To the extent that the deductions in the **Example** were taken in full on the prior year tax returns of the C corporations and no separate payment by the shareholder was reported by the shareholder on the shareholder's tax return for the value creation of the marketing intangible in prior years, such a prior tax position by the shareholder is now inconsistent with a shareholder assertion in the later tax year that the resulting marketing intangible is now significant and is in fact separately owned by the shareholder and not the controlled C corporation. By not reporting income on the shareholder tax return as and when the marketing intangible was being created via expenses incurred by the C corporation, the shareholder's assertion that it was the beneficiary of these expenditures all along seems inconsistent with the earlier tax positions taken on the shareholder's tax returns in prior years.

86. Treas. Reg. § 1.162-1(a) (as amended in 1993); Treas. Reg. § 1.162-2(b)(1) (1960); Treas. Reg. § 1.274-2(c)(3)(i) (as amended in 1996).

The “duty of consistency doctrine” is a judicially created doctrine that prevents a taxpayer from taking advantage of a past misrepresentation in a year now closed by thereafter changing positions and thus avoiding a present tax on the grounds that more tax should have been paid in the prior year.⁸⁷ When this situation arises, “the Commissioner may act as if the previous representation, on which he relied, continued to be true, even if it is not. The taxpayer is estopped to assert the contrary.”⁸⁸ The rule’s purpose is to “preclude parties from playing fast and loose with the courts” by taking a position in a given tax year and then taking a contrary position once the statute of limitations has run on that taxable year.⁸⁹

In *McMillan v. United States*,⁹⁰ the District Court attempted to distill the taxpayer’s duty of consistency doctrine into three elements: (1) the taxpayer made a representation of fact or reported an item for tax purposes in one year;⁹¹ (2) the IRS acquiesced in or relied upon that fact for that year,⁹² and (3) the taxpayer desires to change the representation, previously made, in a later tax year after the first year has been closed.⁹³ This articulation was endorsed by *Beltzer v. United States*⁹⁴ and has since been widely endorsed.⁹⁵

In the cases set forth that have ruled against the taxpayer in section III.B., *infra*, the facts appear to have been that the controlled C corporation bore the ongoing costs associated with business development, client contact, marketing, and research and development expenditures. Having so deducted these costs as a corporate-level expenditure without reimbursement by the shareholder, it is inconsistent to then claim that the results of these expenditures are owned by the shareholder and not by the corporation. Such an assertion is inconsistent with the deductions taken on the C corporation tax return

87. *Lewis v. Comm’r*, 18 F.3d 20, 26 (1st Cir. 1994) (citing *Beltzer v. United States*, 495 F.2d 211, 212–13 (8th Cir. 1974)); *S. Pac. Transp. Co. v. Comm’r*, 75 T.C. 497, 559–61 (1980).

88. *Eagan v. United States*, 80 F.3d 13, 17 (1st Cir. 1996) (quoting *Herrington v. Comm’r*, 854 F.2d 755, 758 (5th Cir. 1988)).

89. *Estate of Ashman v. Comm’r*, 231 F.3d 541, 543 (9th Cir. 2000) (quoting *Russell v. Rolfs*, 893 F.2d 1033, 1037 (9th Cir. 1990)) (internal quotation marks omitted).

90. *McMillan v. United States*, No. 2769, 1964 WL 12375 (S.D. W. Va. 1964).

91. *Id.* at *2. Courts have relied upon the doctrine when the earlier year is closed, the earlier year was agreed between the IRS and the taxpayer, or an inconsistency exists between beneficiaries and estates. *See generally*, BORIS I. BITTKER, MARTIN J. McMAHON, JR. & LAWRENCE A. ZELENAK, *FEDERAL INCOME TAXATION OF INDIVIDUALS* ¶51.09 (3d ed. 2011).

92. *McMillan*, 1964 WL 12375, at *2. Case law indicates that the IRS’s acceptance of a filed tax return is sufficient to satisfy this element of the duty of consistency doctrine. *See Arberg v. Comm’r*, 94 T.C.M. (CCH) 215 (T.C. 2007) (citing cases).

93. *McMillan*, 1964 WL 12375, at *2.

94. *Beltzer v. United States*, 495 F.2d 211 (8th Cir. 1974).

95. *See* Steve R. Johnson, *The Taxpayer’s Duty of Consistency*, 46 TAX. L. REV. 537 (1991).

in prior years. Accordingly, the shareholder should be prevented under the duty of consistency doctrine from claiming that shareholder-level personal goodwill now exists and is owned by the shareholder when the prior tax returns demonstrate the opposite assertion in prior periods. To date, none of the cases that address the existence of shareholder personal goodwill cite the duty of consistency doctrine, but the Ninth Circuit in *Howard v. United States*⁹⁶ uses language that is consistent with the duty of consistency doctrine as indicated in the following excerpt:

Finally, the Taxpayers concede that Dr. Howard chose to conduct his business as a C corporation to take advantage of tax benefits that accrued to him over the years. As one of the members of the panel aptly observed at oral argument, “so having then made himself available to the advantages of using the corporation, and having entered into the agreements that he did with the corporation, then why should we try then to allow him . . . out of what he got himself into.”⁹⁷

The above statement, albeit not citing the duty of consistency doctrine line of cases, is consistent with the case law that holds that the shareholder should have significant equitable constraints in claiming the existence of shareholder-level personal goodwill if in fact in prior years the ongoing customer-related expenses that created the positive business reputation, i.e., the marketing intangible, were borne entirely by the controlled C corporation and deducted on its prior year’s tax returns as ordinary and necessary business expenses of the controlled C corporation.

In the situation posited in the **Example**, the controlled C corporation’s deduction of the ongoing marketing and business development expenses in full constitutes a representation that no significant marketing intangible owned by the shareholder was created. Otherwise, the shareholder should have reimbursed the controlled C corporation for the benefit of this intangible on an ongoing basis in an amount equal to the value of this enhancement using the commensurate with income standards of existing transfer pricing regulations.⁹⁸ By deducting these customer-contact expenses on the controlled C corporation’s tax return without reimbursement—whether advertising, marketing, business development, and research and development expenditures—the C corporation and Shareholder in the **Example** have made a prior representation that they now seek to disavow in order to obtain a significant tax benefit at the time of the disposition of the self-created intangible. In this situation, even if the taxpayer’s latter assertion were factually true, the duty of consistency doctrine would

96. *Howard v. United States*, 448 F. App’x 752 (9th Cir. 2011).

97. *Id.* at 754–55 (alteration in original) (quoting Audio Recording of Oral Argument, *id.*).

98. Treas. Reg. § 1.482-4(f)(2) (1994); Treas. Reg. § 1.482-4(f)(4) (1994).

estop the shareholder from claiming that it is entitled to the benefit of this marketing intangible.

An argument might be made that the duty of consistency doctrine does not extend to issues involving goodwill or going concern value. This argument would be based on the subsequent administrative concessions made by the IRS after its victory in *Hillsboro National Bank v. Commissioner*.⁹⁹

In *Hillsboro*, the Supreme Court held that the tax benefit rule was implicated to create a corporate-level tax when previously deducted inventory was distributed to its shareholders.¹⁰⁰ In this situation, the Court stated that the *General Utilities* doctrine would not shelter the corporate-level tax on a distribution of previously expensed inventory because the distribution of such expensed inventory was fundamentally inconsistent with the allowance of the prior deduction.¹⁰¹ In dissent, Justice Stevens questioned the Supreme Court's application of the tax benefit rule in the fact pattern presented in *Hillsboro* by positing the following hypothetical:

It is not clear, however, how the Court would react to other expenses that provide an enduring benefit. I find no limiting principle in the Court's opinion that distinguishes cattle feed . . . from prepaid rent, prepaid insurance, accruals of employee vacation time, advertising, management training, or any other expense that will have made the going concern more valuable¹⁰²

The logic of Justice Stevens's argument called into question whether and to what extent the *General Utilities* doctrine might apply to distributions that involved self-created intangibles and whether the affirmative use of the *General Utilities* doctrine might create a recapture item to the distributing corporation. Congress largely endorsed Justice Stevens's consistency argument when it repealed the *General Utilities* doctrine outright in the 1986 Act.¹⁰³ However, as to whether the subsequent disposition of self-created intangibles creates an ordinary income recapture item, the IRS allayed concerns about the ordinary versus capital implications of the *Hillsboro* decision by issuing Rev. Rul. 85-186.¹⁰⁴ In this ruling, the IRS stated that deductions claimed for research and development costs pursuant to § 174(a) need not be recaptured as ordinary income under the tax benefit rule upon the subsequent sale of the self-created intangible.¹⁰⁵ This ruling provided authority for the proposition that the prior deduction of such costs was not a "fundamentally inconsistent event" that would require

99. *Hillsboro Nat'l Bank v. Comm'r*, 460 U.S. 370 (1983).

100. *Id.* at 402.

101. *Id.* at 397-98.

102. *Id.* at 419.

103. For a discussion of the repeal of the *General Utilities* doctrine, see *supra* notes 10-15 and accompanying text.

104. Rev. Rul. 85-186, 1985-2 C.B. 84.

105. *Id.*

recapture once the self-created intangible was subsequently disposed. The scope of this administrative concession is debatable. Respected commentators have called for the gain on disposition of goodwill to be treated as ordinary income.¹⁰⁶

Importantly, unlike the fact pattern set forth in the **Example**, Rev. Rul. 85-186 dealt only with a potential character inconsistency. Rev. Rul. 85-186 did not posit a situation where one taxpayer incurred the expense associated with creating the intangible and a different taxpayer attempted to claim the self-created intangible's economic rights. Although Rev. Rul. 85-186 indicates that the IRS will ignore potential character inconsistencies, it does not mean that the IRS would be oblivious to inconsistencies that go to the fundamental question of which party benefitted from the cost that created the intangible. To the extent that the C corporation in the **Example** claimed marketing, advertising, and research and development expenditures as a business deduction, it is inconsistent to state that this was in fact related to the creation of an intangible attributable to these expenditures that is owned at the shareholder level, and Rev. Rul. 85-186 does not speak to an inconsistency of this nature. As a result, the better view is that Rev. Rul. 85-186 should not have any bearing on the fact pattern set forth in the **Example**, and thus the inconsistency issue contained in the **Example** should be resolved under the legal standards set forth by *Beltzer* and other cases involving the duty of consistency doctrine.

B. Residual Goodwill Resides With the Business

It is undisputed that the personal ability and aptitude of an individual belongs to the individual. For example, the Tax Court in *MacDonald v. Commissioner*¹⁰⁷ stated that it found "no authority which holds that an individual's personal ability is part of the assets of a corporation by which he is employed where, as in the instant cases, the corporation does not have a right by contract or otherwise to the future services of that individual."¹⁰⁸ The Tax Court in *Norwalk v.*

106. Calvin H. Johnson, *Sale of Goodwill and Other Intangibles as Ordinary Income*, TAX NOTES TODAY, January 15, 2008, available at LEXIS, 2008 TNT 10-31.

107. *MacDonald v. Comm'r*, 3 T.C. 720 (1944). The taxpayer in *MacDonald* was the sole owner of a corporation that conducted an insurance brokerage business. The taxpayer liquidated the corporation at a time when the value of its tangible assets was less than the liabilities assumed by the taxpayer from the liquidation. The taxpayer reported no gain from the liquidation. The IRS argued that the corporation had valuable goodwill at the time of liquidation and assessed a gain from the transaction. The Tax Court found that the corporation had no goodwill at the time of liquidation and held in favor of the taxpayer. *Id.* at 730.

108. *Id.* at 727; see also *Cullen v. Comm'r* 14 T.C. 368 (1950) (The taxpayer in *Cullen* was one of four equal shareholders who owned a corporation engaged in the business of selling orthopedic devices and artificial limbs; the taxpayer bought out the

Commissioner,¹⁰⁹ references this part of the analysis in *MacDonald* when concluding that the liquidation of a C corporation engaged in the business of delivering accounting services did not involve a transfer of goodwill to its shareholders in light of the absence of employment or covenant-not-to-compete agreements applicable to the shareholders.¹¹⁰ The IRS asserted that the customer list held by the C corporation represented a separate and distinct asset that created a corporate-level gain at the time of the liquidation. After citing *MacDonald* and *Providence Mill Supply Co.*, discussed *infra*, among other cases, the Tax Court held that the C corporation did not realize any gain because no goodwill existed at the corporate level. The court based its holding on its finding that no transferrable “customer-based intangible” existed that was independent of the abilities, skills, and reputation of the individual accountants. As a result, there simply was no goodwill.

However, the fact that such personal attributes are retained and could have contributed to the creation of goodwill of the corporate employer, had appropriate contractual or other rights existed, does not mean that they constitute transferable goodwill in the hands of the individual for tax purposes. The first expression of this premise generally is attributed to the Board of Tax Appeals’ opinion in *Providence Mill Supply Co. v. Commissioner*¹¹¹ where the court stated that “[a]bility, skill, experience, acquaintanceship, or other personal characteristics or qualifications *do not constitute good will* as an item of property; nor do they exist in such form that they could be the subject

other three shareholders and immediately thereafter liquidated the corporation. The purchase price paid by the taxpayer was in excess of the book value of the corporation’s assets. The taxpayer claimed a loss from the liquidation on those grounds. The IRS argued that the purchase price indicated that the corporation had value in excess of the book value of its assets—i.e., goodwill—and assessed a gain with respect to the 25% of the corporation previously owned by the taxpayer. The Tax Court concluded that the corporation had no goodwill and found that the taxpayer recognized neither gain nor loss from the liquidation.); *Taracido v. Comm’r*, 72 T.C. 1014 (1979) (corporation engaged in insurance brokerage business claimed that settlement proceeds from a lawsuit against insurance company were not taxable on the grounds that it was in consideration for destruction, in part, of corporation’s goodwill; the Tax Court found that the corporation did not have any goodwill and thus did not reach the merits of the taxpayer’s technical argument).

109. *Norwalk v. Comm’r*, 76 T.C.M. 208 (1998).

110. *Id.*

111. *Providence Mill Supply Co. v. Comm’r*, 2 B.T.A. 791 (1925). The taxpayer in *Providence* was a corporation trying to reduce its tax for 1919 and 1920 on the grounds that it acquired goodwill from its founding shareholder as a contribution to capital. Thus, it could be included as part of “invested capital,” which apparently gave it some advantage under the tax law applicable at the time.

of transfer.”¹¹² Similarly, the Tax Court in *MacDonald v. Commissioner*¹¹³ quoted with approval its statement in *Wickes Boiler Co. v. Commissioner* that “the ability, will, experience, or other qualifications of individuals *do not constitute good will as an item of property*.”¹¹⁴

For an individual’s personal aptitude to create an asset that can be sold, the asset must be transferrable independent of the personal reputation of the individual.¹¹⁵ When an individual’s customer relationships create residual goodwill and not a separate and distinct marketing intangible, the courts have concluded that the residual goodwill is associated with the business and is inseparable from the underlying business assets. For example, in *Horton v. Commissioner*,¹¹⁶ Mr. Horton entered into a contract to sell his accounting practice, which was then operated as a sole proprietorship, to another accounting firm. At that time, Mr. Horton had several employees working for him. The buyer agreed to pay Mr. Horton: (a) \$2,500 at closing, which the Tax Court found was in exchange for the tangible assets used in the accounting practice; (b) \$416.66 each month for the last three months of 1941, which the Tax Court found was in exchange for the personal services contemplated in the contract; and (c) 10% of all fees collected by the buyer from Mr. Horton’s office location for five years and 15% for certain audit engagements for governmental agencies.¹¹⁷ This last category of payment was the subject of the case.

Mr. Horton reported all amounts received from the third category as received from the sale of goodwill, and thus reported long-term capital gain from that component of the transaction. The IRS audited Mr. Horton’s tax returns for 1942 and 1943, and took the position that all amounts received by Mr. Horton from the third category of payments should be allocated to a covenant not to compete that the parties en-

112. *Id.* at 793 (emphasis added). Additionally, the Board of Tax Appeals in *Sommers v. Comm’r*, 22 B.T.A. 1241 (1931), quoted with approval its statement of analysis in *Braunwarth v. Comm’r*, 22 B.T.A. 1008 (1931), to the effect that “[i]t may be conceded that the petitioner had built up a considerable clientele and business acquaintanceship, and that this clientele followed him to a large extent, during his various enterprises. *But this personal following does not constitute good will within the generally accepted meaning of the term.*” *Sommers*, 22 B.T.A. at 1244 (alteration in original) (emphasis added) (quoting *Braunwarth*, 22 B.T.A. at 1023).

113. *MacDonald v. Comm’r*, 3 T.C. 720 (1944).

114. *MacDonald*, 3 T.C. at 727 (emphasis added) (quoting *Wickes Boiler Co. v. Comm’r*, 15 B.T.A. 1118, 1122 (1929) (internal quotation marks omitted)).

115. This statement of the law, which was articulated in cases such as *Providence Mill Supply Co.* and *MacDonald*, is now explicitly stated in Treas. Reg. § 1.482-4(b) (“[A]n intangible is an asset that comprises any of the following items and has substantial value independent of the services of any individual.”).

116. *Horton v. Comm’r*, 13 T.C. 143 (1949).

117. *Id.* at 148.

tered into as part of the transaction (and thus taxable as ordinary income).¹¹⁸

The Tax Court found that 50% of the amounts from the third category were attributable to the goodwill and 50% were attributable to the covenant not to compete.¹¹⁹ In the end, it appears that the Tax Court may have simply adopted the fifty-fifty approach as a compromise to resolve the case. Nonetheless, the discussion does take into account the fact that Mr. Horton sold goodwill to the buyer, and this conclusion allowed him to recognize some capital gain with respect to the sale. However, it was only because he was conducting the business as a sole proprietor and thus by necessity was the owner of the overall business that he was the seller of the goodwill and other business assets.

Similarly, in *Watson v. Commissioner*,¹²⁰ Mr. Watson entered into a contract to sell his accounting practice—conducted as a sole proprietorship—to two accountants who were going into practice together. The sale was staged over a ten-year period. The purchase price for the first stage was payable in installments. Mr. Watson took the position that the gain he recognized from receipt of the first installment was long-term capital gain from the disposition of goodwill associated with his accounting practice. The IRS asserted that it was ordinary income from the assignment of future earnings. The Tax Court cited *Providence Mill Supply Co.*¹²¹ for the standard that a person's ability, skill, experience, acquaintanceship, and other personal characteristics and qualifications are not part of goodwill that can be conveyed to another person.¹²² The Tax Court further said that the "position that personal characteristics or qualifications do not constitute goodwill as an item of property as may be the subject of transfer is consonant with our views on the subject."¹²³ The Tax Court concluded that residual goodwill associated with the business did exist. However, as in the *Horton* case, the residual goodwill was sold as part of the entire business, including all of the business assets, by the sole proprietor. As a result, the Tax Court supported Mr. Watson's position.

118. *Id.* at 148. The parties entered into the covenant-not-to-compete in order to protect the buyer against Mr. Horton using his accounting firm's name after the closing and thereby harming the goodwill that the buyer had bargained to acquire as part of the transaction.

119. *Id.* at 149. See also *Wyer v. Comm'r*, 14 T.C. 1251 (1950) (upholding the allocation to goodwill where Wyer sold an accounting practice to Peat Marwick, Mitchell & Co. and reported goodwill on the sale, but like *Horton*, the seller of the goodwill was selling the entire business assets to which the goodwill was inseparable from).

120. *Watson v. Comm'r*, 35 T.C. 203 (1960).

121. *Providence Mill Supply Co. v. Comm'r*, 2 B.T.A. 791 (1925).

122. *Watson*, 35 T.C. at 210.

123. *Id.*

In *Howard v. United States*,¹²⁴ which is the most recent case in this area, Dr. Howard practiced dentistry for many years as a sole proprietor until 1980, at which time he transferred his dental practice to a corporation, the Howard Corporation.¹²⁵ Also in 1980, Dr. Howard entered into an employment agreement and a covenant-not-to-compete with the Howard Corporation. In 2002, Dr. Howard and the Howard Corporation sold the dental practice to another dentist and that dentist's own corporation. The transaction was structured so that nearly 90% of the sales proceeds were allocated to Dr. Howard's personal goodwill, and as a result Dr. Howard reported \$320,358 of long-term capital gain from the transaction. The balance of the purchase price was allocated to the Howard Corporation in exchange for assets.

The IRS recharacterized the transaction as a sale of goodwill by the Howard Corporation and treated Dr. Howard as having received a dividend distribution from the Howard Corporation in the amount of \$320,358. The District Court found that, because Dr. Howard was prohibited by the employment and covenant-not-to-compete agreements from entering into a competitive dental practice with Howard Corporation, any goodwill generated during the term of the agreement belonged to the Howard Corporation. Furthermore, the District Court indicated that this conclusion was further supported by the fact that all income from the dental practice was reported by Howard Corporation. Accordingly, the District Court ruled in favor of the IRS.¹²⁶

The Ninth Circuit affirmed the District Court's decision in *Howard*, stating that any goodwill created by the personal services of Dr. Howard was owned by the Howard Corporation which had paid for all of Dr. Howard's operating expenses for three years.¹²⁷ The Ninth Circuit focused on the terms and conditions of the employment and covenant-not-to-compete agreements between Dr. Howard and the Howard Corporation. However, given the broad authority for the IRS to impute the existence of an employment agreement under Treas. Reg. § 1.482-1(d)(3)(ii)(B)(1) when the controlled C corporation fully funded the creation of the self-created intangible, it would be difficult to believe that the existence or non-existence of a formal employment agreement, or a formal covenant-not-to-compete, should have made any practical difference to the Ninth Circuit.¹²⁸ Furthermore, in this regard, the Ninth Circuit observed in reaching its conclusion that Dr.

124. *Howard v. United States*, No. CV-08-365-RMP, 2010 WL 3061626 (E.D. Wash. Jul. 30, 2010), *aff'd*, *Howard v. United States*, 448 F. App'x 752 (9th Cir. 2011).

125. *Id.* at *1.

126. *Id.* at *6.

127. *Howard*, 2011 WL 3796723, at *755.

128. The facts in *Howard* included a related-party situation to which I.R.C. § 482 clearly applies, as also is true with respect to the fact pattern set forth in **The Example**. See *supra* notes 58-66 and accompanying text for a discussion of the

Howard chose to conduct his dental practice through the Howard Corporation in order to take advantage of tax benefits that accrued to him over the years. After citing comments made by one of the Ninth Circuit panel members during oral argument, the Ninth Circuit indicated that it would not be appropriate to allow Dr. Howard to circumvent the consequences of that structure through this dispositional planning technique.¹²⁹

In *Kennedy v. Commissioner*,¹³⁰ another recent case in this area, James Kennedy was an employee benefits consultant who began working as a sole proprietor in 1990 and then in 1995 transferred his practice to a newly organized controlled C corporation named KCG International, Inc. (KCG) in 1995. Mr. Kennedy did not have an employment agreement or covenant-not-to-compete with KCG.¹³¹ KCG had one other employee in addition to Mr. Kennedy.

During 2000, Mr. Kennedy was approached by Mack & Parker, Inc. (Mack) about the opportunity for Mack to acquire Mr. Kennedy's business. The transaction closed on October 31, 2000, and was effectuated with three interrelated contracts: (1) an Agreement for Assignment of Know-How and Goodwill; (2) an Asset Purchase Agreement; and (3) a Consulting Agreement. The goodwill agreement provided that Mr. Kennedy (a) conveyed his special personal relationships with 46 clients set forth on a list attached to the agreement, as well as his personal goodwill incident to such relationships, (b) conveyed his know-how with respect to the business, and (c) would not engage in the employee benefits consulting business—except for working with Mack—through 2007. In exchange for such agreements, Mack agreed to pay Kennedy the sum of \$176,100 on January 2, 2001, and to make five annual payments from 2002–2006, the amounts of which were determined by formula based on collections from KCG's clients. The transaction was structured in the foregoing manner based on tax advice received by Mr. Kennedy toward the end of his negotiation with Mack.

On their tax return for 2001, Mr. and Mrs. Kennedy reported the \$176,100 as proceeds from the sale of goodwill and intangibles, thereby generating gain from the sale of a long-term capital asset. Similarly, on their tax return for 2002, Mr. and Mrs. Kennedy reported the \$32,757.94 that they received from Mack during 2002 under the goodwill agreement as proceeds from the sale of goodwill and intangibles, thereby generating gain from the sale of a long-term

broad re-characterization authority provided to the IRS under the final I.R.C. § 482 regulations.

129. *Howard*, 2011 WL 3796723, at *755.

130. *Kennedy v. Comm'r*, 100 T.C.M. (CCH) 268 (T.C. 2010).

131. This is in contrast to Dr. Howard, who had both types of agreements with the Howard Corporation. *Howard*, 2010 WL 3061626, at *3.

capital asset. The IRS recharacterized all of these amounts as ordinary income.

The Tax Court held, based on the facts and circumstances in this case, that “the payments to Kennedy were consideration for services rather than goodwill.”¹³² In this regard, the Tax Court said:

Here, however, the allocation of 75 percent of the total consideration paid by Mack & Parker to goodwill was a tax-motivated afterthought that occurred late in the negotiations . . . the decision to allocate 75 percent of the total payments to goodwill appears not to be grounded in any business reality. It did not reflect the value of goodwill in relation to the other valuable aspects of the transaction, such as the services to be performed by Kennedy for Mack & Parker. Rather the 75 percent allocation was driven by a desire to minimize taxes.¹³³

As a result, the Tax Court determined that “the payments Kennedy received were not payments for goodwill,” and that they “are includable in ordinary income.”¹³⁴

The above authorities involve factual determinations that are particular to the facts and circumstances before the court. However, they can be synthesized as follows:

1. Personal ability and relationships, by themselves, do not constitute goodwill. If the Shareholder in the **Example** is paid for the Shareholder’s personal ability and relationships as was the case in *Kennedy* and *Norwalk*, then that payment represents ordinary compensation income to the shareholder, not a payment in exchange for personal goodwill. Such payments could be made pursuant to employment, consulting, or covenant-not-to-compete arrangements.¹³⁵ Because these agreements generate ordinary income to the selling shareholder, they are not as advantageous for selling shareholders as a sale of personal goodwill purports to be, since, if it were viable, such a sale would generate capital gain. However, when respected, amounts paid under such arrangements generate taxable income only at the shareholder level and in that sense provide an alternative means to avoid the corporate-level tax. If the amounts paid were unreasonable considering the entirety of the

132. *Kennedy*, 100 T.C.M (CCH) at 274.

133. *Id.*

134. *Id.* For a similar result, see also *Solomon v. Comm’r*, 95 T.C.M. (CCH) 1389 (2008) (taxpayer allocated sales price to customer list/goodwill; the Tax Court held that the proceeds should entirely be allocated to the shareholder’s covenants-not-to-compete and taxed at ordinary income rates because the court did not believe a separately created marketing intangible existed).

135. Employment, consulting, and covenant-not-to-compete arrangements are a traditional part of dispositional tax planning, including for circumstances such as those present in the **Example**. See Michael Schlesinger, *Covenants Not to Compete Are Still Useful After RRA ’93*, 51 TAX’N FOR ACCT 204 (1993); Bruch A. Rich, *Handling Covenant Not to Compete Negotiations to Assure Tax Benefits and Preclude Challenges*, 24 TAX’N FOR ACCT 354 (1980).

circumstances, then the amounts paid are simply disguised consideration for something else, such as the goodwill of the underlying C corporation.¹³⁶ The IRS has issued guidelines for auditing amounts allocated to covenant-not-to-compete, employment and consulting arrangements that require such arrangements to comport with economic reality for this very reason.¹³⁷

2. If the Shareholder's personal services in the **Example** create residual goodwill for the underlying business, then that residual goodwill is attributable to the business and can only be sold as part of the business assets. When those business assets are owned as a sole proprietorship as in *Horton and Watson*, then the goodwill is sold with the overall assets by the sole proprietor and can generate long-term capital gain for the proprietor. However, when the business assets are owned by the proprietor's C corporation as was the case in *Howard*, then the residual goodwill is inseparable from those assets and is owned by the controlled C corporation.
3. If a separate and distinct intangible exists that can be segregated from the operating business assets, then that separate and distinct asset is subject to the allocation rules of § 482 as a marketing intangible.

Importantly, what is not contemplated in either existing case law or the § 482 regulations is the idea that there can be goodwill that is an asset separate and distinct from the underlying operating business assets and yet is not subject to § 482's transfer pricing allocation rules that apply to intangibles. If a separate and distinct intangible exists in the context of a related party shareholder and controlled corporation context, then Treas. Reg. § 1.482-4 applies to that arrangement and tax planning premised on its non-applicability is highly questionable.

IV. CORPORATE TAX REFORM IMPLICATIONS

The judicial doctrines of business purpose, device, and step transaction grew out of an era when the courts were attempting to defend the corporate tax base against efforts that would eliminate corporate-

136. See *Balthorpe v. Comm'r*, 356 F.2d 28 (5th Cir. 1966).

137. See *ISP Settlement Guideline Explores Amortization of Employment Contracts*, TAX NOTES TODAY, Oct. 24, 1997, available at LEXIS 97 TNT 206-25; *Revised ISP Paper Examines Covenants Not To Compete*, TAX NOTES TODAY, Feb. 19, 1996, available at LEXIS 96 TNT 49-25. The adversity of interest between the buyer and the seller in these instances may not be strong enough to appropriately defend against attempts to circumvent the repeal of the *General Utilities* doctrine, and so further legislation or regulatory guidance may be needed with respect to these arrangements. Such issues are worthy of further study but are beyond the scope of this paper.

level taxation. But even with these protections, the fact remains that the ability of taxpayers to choose whether or not to conduct business activity in pass-through entities challenges the efficacy of a corporate income tax regime.¹³⁸ Several commentators have seen this trend of disincorporation of domestic business activity and have called on Congress to enact a business-entity tax that applies regardless of the tax classification of the particular business entity, whether C corporation, S corporation, partnership, or other pass-through entity.¹³⁹ Repeated attempts have been made to seriously consider an integrated shareholder-corporation tax system.¹⁴⁰ In May 2011, the Treasury Department indicated that it was considering a proposal to tax all businesses with \$50 million of revenue or more as C corporations.¹⁴¹ Others have called for the outright repeal of the corporate income tax entirely for all nonpublicly traded entities,¹⁴² variations of shareholder-corporate integration,¹⁴³ or for the tax deductibility of dividends.¹⁴⁴ Reform in this area was endorsed by a recent commission appointed by President Obama to study the issue of corporate tax reform.¹⁴⁵

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138. See Martin A. Sullivan, *Passthroughs Shrink the Corporate Tax by \$140 Billion*, TAX NOTES TODAY, Feb. 28, 2011, available at LEXIS 2011 TNT 39-2.
139. Martin A. Sullivan, *Why Not Tax Large Passthroughs as Corporations?*, 131 TAX NOTES 1015 (2011).
140. See AMER. LAW INST., FEDERAL INCOME TAX PROJECT: INTEGRATION OF THE INDIVIDUAL AND CORPORATE INCOME TAXES: REPORTER'S STUDY OF CORPORATE TAX INTEGRATION (1993); U.S. DEPT. OF THE TREASURY, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE (1992), available at <http://www.treasury.gov/resource-center/tax-policy/Documents/integration.pdf>.
141. See Ryan J. Donmoyer, *Geithner Says Tax Overhaul Must Address Businesses Filing as Individuals*, BLOOMBERG (Feb. 24, 2011, 11:01 PM), <http://www.bloomberg.com/news/2011-02-25/geithner-says-tax-overhaul-must-address-businesses-filing-as-individuals.html>; Sullivan, *supra* note 125; but see Bradley T. Borden, *Three Cheers for Pass-Through Taxation*, TAX NOTES TODAY, June 27th, 2011, available at LEXIS 2011 TNT 124-5.
142. AM. LAW INST., FEDERAL INCOME TAX PROJECT: TAXATION OF PRIVATE BUSINESS ENTERPRISES (1999); see also U.S. DEPT. OF THE TREASURY, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE (1992), available at <http://www.treasury.gov/resource-center/tax-policy/Documents/integration.pdf> (advocating in favor of integration); Katherine Pratt, *The Debt-Equity Distinction in a Second-Best World*, 53 VAND. L. REV. 1055 (2000).
143. See, e.g., Joseph M. Dodge, *A Combined Mark-to-Market and Pass-Through Corporation-Shareholder Integration Proposal*, 50 TAX L. REV. 265 (1995).
144. Amir C. Chenchinski & Reuven S. Avi-Yonah, *The Case for Dividend Deduction*, (Univ. of Michigan Pub. Law, Working Paper No. 220, 2010), available at <http://ssrn.com/abstract=1680219>.
145. PRESIDENT'S ECON. RECOVERY ADVISORY BD., Doc. 2010-19068, THE REPORT ON TAX REFORM OPTIONS: SIMPLIFICATION, COMPLIANCE, AND CORPORATE TAXATION, at 74-77 (Aug. 2010).

The existing entity classification regime violates norms of horizontal equity¹⁴⁶ because it creates significant differences in the tax treatment afforded to similar activities depending on the form in which such business activity is conducted. The fundamental question is this: if we are going to have a corporate income tax and if this tax regime is designed to tax the business activities that occur in this country, then how does one reconcile this objective with the current scope of the pass-through entity classification regime that exists under current law? If the explosive growth of pass-through entity taxation was intended by Congress, then statements by Congress in the legislative history to the 1986 Act that purported to defend the “classic view” of separate corporate-level taxation as the justification for the repeal of the *General Utilities* doctrine failed to hit the mark. Instead of defending the corporate tax base, the 1986 Act has resulted in a significant erosion of the corporate tax base except with respect to publicly traded entities that are unable to escape corporate taxation due to § 7704.

Continued inaction on the part of Congress represents a defacto endorsement of pass-through treatment for nonpublicly traded businesses since existing law favors the use of pass-through entities and taxpayers are given the discretion under current law to choose the tax status for their businesses as long as the businesses are not conducted in “per se” entities and do not fall within the scope of § 7704. Seen in this light, the imposition of a corporate-level tax in the fact pattern set forth in the **Example** and *Howard* represents a piecemeal imposition of corporate taxation and creates a significantly higher tax cost for businesses conducted in closely-held C corporations compared with similarly situated businesses conducted in pass-through entity structures. Consequently, at least in the context of closely-held businesses, it is past time for Congress to rationalize the taxation of nonpublicly traded business entities regardless of their tax classification.

V. CONCLUSION

It is a great historical irony that the 1986 Act purported to protect the corporate tax base by repealing the *General Utilities* doctrine because in hindsight the 1986 Act was in fact the death knell for a broad-based corporate income tax. The 1986 Act provided a relatively higher corporate tax rate versus individual rates, which allowed taxpayers a choice in how to conduct their business activities making it more difficult to distribute appreciated assets out of corporate solution without incurring corporate-level taxation. The seeds of the destruc-

146. See Boris I. Bittker, *Equity, Efficiency, and Income Tax Theory: Do Misallocations Drive Out Inequities?*, in *THE ECONOMICS OF TAXATION* 19 (Henry J. Aaron & Michael J. Boskin eds., 1980).

tion of the corporate tax base were planted at the very instant Congress was professing to defend it.

One is left with a certain uneasiness about the current state of affairs. Taxpayers that could elect S corporation status and delay disposition of built-in gain assets owned by the controlled S corporation for five, seven, or ten years, depending on the year of disposition, can avoid any corporate-level taxation on goodwill regardless of its ownership. New businesses can easily avoid any corporate-level taxation if the taxpayer elects to treat the business enterprise as a pass-through entity from the outset. Given these significant tax concessions for avoidance of the corporate-level tax, what is the fundamental interest that Congress continues to desire to protect with respect to corporate income taxation of closely-held businesses? At present, at least in the context of closely-held companies, the tax system seems to create winners and losers that have very little to do with the fundamentals of business and economic activity. Congress should reexamine the contours of the corporate income tax regime and decide whether it wants to defend and broaden the corporate tax base or scrap it entirely for all nonpublic entities. The significant disincorporation that has occurred since the 1986 Act creates a serious challenge to the continued efficacy of the corporate income tax regime as applied to closely-held businesses and creates artificial distinctions that violate norms of horizontal equity.

Until a broader policy review is conducted, the courts should, and likely will, protect the corporate tax base in a manner consistent with current law. At first blush, arguments that claim that the Shareholder in the **Example** is the tax owner of a capital asset comprised of the personal goodwill appear solid. But when the logical conclusions of the arguments are worked through existing law, the result is that these claims are simply not supportable based on the facts posited in the **Example**. If the Shareholder claims the intangible asset that exists in the **Example** represents residual goodwill that cannot be separated into a discrete marketing intangible, then it cannot be separated from the operating business assets, which in the context of the **Example**, are owned by the controlled C corporation.

However, if the Shareholder claims that there is a shareholder-owned intangible that is a separate and distinct intangible that can be transferred, i.e., a marketing intangible exists, then at that instance § 482 and its regulations come into play because those provisions apply any time an intangible can be separated from the legal personality and transferred between related persons. The § 482 regulations would find that the economic benefits of any intangible that might exist in the **Example** would be allocated to the C corporation because the C corporation funded the enhancement in value of the marketing intangible. Furthermore, if the Shareholder did not reimburse the C

corporation in prior periods for the enhancement of value of the Shareholder's marketing intangible, then the IRS would also have estoppel arguments based on the duty of consistency doctrine.

Finally, cases such as *MacDonald* and *Providence Mill Supply Co.* have long provided that personal ability, skill, experience, relationships, or other personal characteristics or accomplishments that are retained by an individual simply do not constitute goodwill or an item of transferrable property for tax purposes. *Martin Ice Cream* simply does not provide any material support for a contrary position. Accordingly, current tax planning that attempts to escape corporate-level taxation in the context of the **Example** based on the idea of transferable personal shareholder-level goodwill attempts to build an argument that unfortunately cannot withstand the sunlight of analysis under current tax law absent the taxpayer's demonstration that some additional legally relevant facts that are not discussed above are implicated in the particular situation.